

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 275

[Release Nos. IA–5955; File No. S7–03–22]

RIN 3235–AN07

### Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission (the “Commission” or the “SEC”) is proposing new rules under the Investment Advisers Act of 1940 (the “Advisers Act” or the “Act”). We propose to require registered investment advisers to private funds to provide transparency to their investors regarding the full cost of investing in private funds and the performance of such private funds. We also are proposing rules that would require a registered private fund adviser to obtain an annual financial statement audit of each private fund it advises and, in connection with an adviser-led secondary transaction, a fairness opinion from an independent opinion provider. In addition, we are proposing rules that would prohibit all private fund advisers, including those that are not registered with the Commission, from engaging in certain sales practices, conflicts of interest, and compensation schemes that are contrary to the public interest and the protection of investors. All private fund advisers would also be prohibited from providing preferential treatment to certain investors in a private fund, unless the adviser discloses such treatment to other current and prospective investors. We are proposing corresponding amendments to the Advisers Act books and records rule to facilitate compliance with these proposed new rules and assist our examination staff. Finally, we are proposing amendments to the Advisers Act compliance rule, which would affect all registered investment advisers, to better enable our staff to conduct examinations.

**DATES:** Comments should be received on or before April 25, 2022.

**ADDRESSES:** Comments may be submitted by any of the following methods:

#### Electronic Comments

- Use the Commission’s internet comment form (<https://www.sec.gov/rules/submitcomments.htm>); or

- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7–03–22 on the subject line.

#### Paper Comments

- Send paper comments to Vanessa A. Countryman, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549–1090. All submissions should refer to File Number S7–03–22. This file number should be included on the subject line if email is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission’s website (<https://www.sec.gov/rules/proposed.shtml>). Comments are also available for website viewing and printing in the Commission’s Public Reference Room, 100 F Street NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Operating conditions may limit access to the Commission’s public reference room. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

Studies, memoranda, or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the Commission’s website. To ensure direct electronic receipt of such notifications, sign up through the “Stay Connected” option at [www.sec.gov](http://www.sec.gov) to receive notifications by email.

#### FOR FURTHER INFORMATION CONTACT:

Christine Schleppegrell, Senior Counsel; Thomas Strumpf, Senior Counsel; Melissa Rovers Harke, Senior Special Counsel; Michael C. Neus, Private Funds Attorney Fellow; or Melissa S. Gainor, Assistant Director, Investment Adviser Rulemaking Office, or Marc Mehrespand, Branch Chief, Chief Counsel’s Office, at (202) 551–6787 or [IArules@sec.gov](mailto:IArules@sec.gov), Division of Investment Management, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549–8549.

**SUPPLEMENTARY INFORMATION:** The Securities and Exchange Commission (the “Commission”) is proposing for public comment 17 CFR 275.206(4)–10 (new rule 206(4)–10), 17 CFR 275.211(h)(1)–1 (new rule 211(h)(1)–1), 17 CFR 275.211(h)(1)–2 (new rule 211(h)(1)–2), 17 CFR 275.211(h)(2)–1 (new rule 211(h)(2)–1), 17 CFR 275.211(h)(2)–2 (new rule 211(h)(2)–2), and 17 CFR 275.211(h)(2)–3 (new rule

211(h)(2)–3) under the Investment Advisers Act of 1940 [15 U.S.C. 80b–1 *et seq.*] (the “Advisers Act”);<sup>1</sup> and amendments to 17 CFR 275.204–2 (rule 204–2) and 17 CFR 275.206(4)–7 (rule 206(4)–7) under the Advisers Act.

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<sup>1</sup> Unless otherwise noted, when we refer to the Advisers Act, or any section of the Advisers Act, we are referring to 15 U.S.C. 80b, at which the Advisers Act is codified. When we refer to rules under the Advisers Act, or any section of those rules, we are referring to title 17, part 275 of the Code of Federal Regulations [17 CFR part 275], in which these rules are published.

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## I. Background and Need for Reform

In the wake of the 2007–2008 financial crisis, Congress passed and the President signed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”), which increased the Commission’s oversight responsibility for private fund advisers.<sup>2</sup> Among other things, the Dodd-Frank Act amended the Advisers Act generally to require advisers to private funds to register with the Commission and to require the Commission to establish reporting and recordkeeping requirements for advisers to private funds for investor protection and systemic risk purposes.<sup>3</sup> The Dodd-Frank Act also added section 211(h) to the Advisers Act, which, among other things, directs the Commission to “facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with . . . investment advisers” and “promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for investment advisers.”<sup>4</sup> Registration and reporting on both Form ADV and Form PF have been critical to increasing transparency and protecting investors in private funds and assessing systemic risk.<sup>5</sup> They also

<sup>2</sup> Section 202(a)(29) of the Advisers Act defines the term “private fund” as an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3) (“Investment Company Act”), but for section 3(c)(1) or 3(c)(7) of that Act. We use “private fund” and “fund” interchangeably throughout this release.

<sup>3</sup> See, e.g., *Rule Implementing Amendments to the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 3221 (June 22, 2011) (“Implementing Release”); *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisers on Form PF*, Investment Advisers Act Release No. 3308 (Oct. 31, 2011).

<sup>4</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, section 913(h), Public Law 111–203, 124 Stat. 1376 (2010).

<sup>5</sup> The Financial Stability Oversight Council uses these and other tools to assess private fund impact on systemic risk. See also U.S. Securities and Exchange Commission, Division of Investment Management, Analytics Office, Private Fund Statistics, available at <https://www.sec.gov/divisions/investment/private-funds-statistics.shtml> (providing a summary of private fund industry statistics and trends based on data collected through Form PF and Form ADV). Staff reports, statistics, and other staff documents (including those cited herein) represent the views of Commission staff and are not a rule, regulation, or statement of the Commission. The Commission has neither approved nor disapproved the content of these documents and, like all staff statements, they have no legal force or effect, do not alter or amend applicable law, and create no new or additional

have substantially improved our ability to understand private fund advisers’ operations and relationships with investors as private funds play an increasingly important role in the financial system and private funds continue growing in size, complexity, and number. There are currently 5,037 registered private fund advisers with over \$18 trillion in private fund assets under management.<sup>6</sup> In addition, private funds and their advisers play an increasing role in the economy. For example, hedge funds engage in trillions of dollars in listed equity and futures transactions each month.<sup>7</sup> Private equity and other private funds are involved in mergers and acquisitions, non-bank lending, and restructurings and bankruptcies. Venture capital funds provide funding to start-ups and early stage companies. Private funds and their advisers also play an increasingly important role in the lives of everyday Americans saving for retirement or college tuition. Some of the largest groups of private fund investors include state and municipal pension plans, college and university endowments, non-profit organizations, and high net worth individuals.<sup>8</sup> Numerous investors also have indirect exposure to private funds through private pension plans, endowments, feeder funds established by banks and other financial institutions, foundations, and certain other retirement plans.

During our decade overseeing most private fund advisers, our staff has examined private fund advisers to assess both the issues and risks presented by their business models and the firms’ compliance with their existing legal obligations.<sup>9</sup> The

obligations for any person. The Commission has expressed no view regarding the analysis, findings, or conclusions contained therein.

<sup>6</sup> Form ADV data current as of November 30, 2021.

<sup>7</sup> See Division of Investment Management: Analytics Office, Private Funds Statistics Report: First Calendar Quarter 2021 (Nov. 1, 2021) (“Form PF Statistics Report”), at 31, available at <https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2021-q1.pdf> (showing aggregate portfolio turnover for hedge funds managed by large hedge fund advisers (*i.e.*, advisers with at least \$1.5 billion in hedge fund assets under management) as reported on Form PF).

<sup>8</sup> See Form PF Statistics Report, *supra* at footnote 7, at 15 (showing beneficial ownership of all funds by category as reported on Form PF). See also, e.g., Public Investors, Private Funds, and State Law, Baylor Law Review, Professor William Clayton (June 15, 2020) (“Professor Clayton Article”), at 354 (noting that public pension plans have dramatically increased their investment in private funds).

<sup>9</sup> See, e.g., OCIE National Examination Program Risk Alert: Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020) (“EXAMS Private Funds Risk Alert 2020”), available at <https://www.sec.gov/files/>

Continued

Commission also has pursued enforcement actions against private fund advisers for practices that have caused private funds to pay more in fees and expenses than they should have, which negatively affected returns for private fund investors, or resulted in investors not being informed of relevant conflicts of interest concerning the private fund adviser and the fund.<sup>10</sup> Despite our examination and enforcement efforts, these activities persist.<sup>11</sup>

First, we continue to observe that private fund investments are often opaque; advisers frequently do not provide investors with sufficiently detailed information about private fund investments. Without sufficiently clear, comparable information, even sophisticated investors would be unable to protect their interests or make sound investment decisions. For example, some investors do not have sufficient information regarding private fund or portfolio company fees and expenses to

make informed investment decisions, given those fees and expenses can be subject to complicated calculation methodologies (that often include the application of offsets, waivers, and other limits); may have varied labels across private funds; and can affect individual investors' returns differently because of alternative fee arrangements set forth in side letter agreements. In addition, advisers often provide private fund investors with laundry lists of potential fees and expenses, without giving details on the magnitude and scope of fees and expenses charged. Beyond management fees, performance-based compensation, and the expenses charged directly to the funds, some private fund advisers and their related persons charge a number of fees and expenses to the fund's portfolio companies. These can include consulting fees, monitoring fees, servicing fees, transaction fees, director's fees, and others. At the time of the initial investment and as fund operations continue, many investors do not have sufficient information regarding these fee streams that flow to the adviser or its related persons and reduce the return on their investment.

Investors also often lack sufficient transparency into how private fund performance is calculated. Advisers frequently present fund performance reflecting different assumptions, making it difficult to measure and compare data across funds and advisers or compare the fund's performance to the investor's chosen benchmarks, even where the assumptions are disclosed. For example, one adviser may show fund performance that reflects the use of a subscription line of credit initially to fund investments and pay expenses rather than investor capital. Another adviser may present only unlevered performance results that do not reflect the effect of a subscription line. More standardized requirements for performance metrics would allow private fund investors to make apples to apples comparisons when assessing the returns of similar fund strategies over different market environments and over time. More standardized requirements for performance information also would improve investors' ability to interpret complex performance reporting, and assess the relationship between the fees paid in connection with an investment and the return on that investment as they monitor their investment and consider potential future investments.

Similarly, investors may not have information regarding the preferred terms granted to certain investors (e.g., seed investors, strategic investors, those with large commitments, and

employees, friends, and family). Advisers frequently grant preferred terms to certain investors that often are not attainable for smaller institutional investors or individual investors. In some cases, these terms materially disadvantage other investors in the private fund.<sup>12</sup>

This lack of transparency regarding costs, performance, and preferential terms causes an information imbalance between advisers and private fund investors, which, in many cases, prevents private bilateral negotiations from effectively remedying shortcomings in the private funds market. We believe that this imbalance serves only the adviser's interest and leaves many investors without the tools they need to effectively protect their interests, whether through negotiations or otherwise. Moreover, certain advisers may only provide sufficiently detailed information following an investor's admission to the fund when the primary bargaining window has closed, particularly for closed-end funds where investors have no, or very limited, options to withdraw.

Enhanced information about costs, performance, and preferential treatment, would help an investor better decide whether to invest or to remain invested in a particular private fund, how to invest other assets in the investor's portfolio, and whether to invest in private funds managed by the adviser or its related persons in the future. More standardized information would improve comparability among private funds with similar characteristics. This information also would help a private fund investor better monitor and assess the true cost of its investments, the value of the services for which the fund is paying, and potential conflicts of interest. For example, enhanced cost information could allow an investor to identify when the private fund has incorrectly, or improperly, assessed a fee or expense by the adviser contrary to the adviser's fiduciary duty, contractual obligations to the fund, or

*Private%20Fund%20Risk%20Alert\_0.pdf*. As of December 17, 2020, the Office of Compliance, Inspections and Examinations ("OCIE") was renamed the Division of Examinations ("EXAMS").

<sup>10</sup> See, e.g., *In re Kohlberg Kravis Roberts & Co. L.P.*, Investment Advisers Act Release No. 4131 (June 29, 2015) (settled action) (alleging private fund adviser misallocated more than \$17 million in so-called "broken deal" expenses to its flagship private equity fund); *In re Blackstone Management Partners L.L.C., et al.*, Investment Advisers Act Release No. 4219 (Oct. 7, 2015) (settled action) (alleging private fund advisers failed to inform investors about benefits that the advisers obtained from accelerated monitoring fees and discounts on legal fees); *In re NB Alternatives Advisers LLC*, Investment Advisers Act Release No. 5079 (Dec. 17, 2018) (settled action) (alleging private fund adviser improperly allocated approximately \$2 million of compensation-related expenses to three private equity funds it advised).

<sup>11</sup> See, e.g., *In the Matter of Diastole Wealth Management, Inc.*, Investment Advisers Act Release No. 5855 (Sept. 10, 2021) (settled action) (alleging private fund adviser failed to disclose to investors that the adviser periodically made loans to a company owned by the son of the principal of the advisory firm and that the private fund's investment in the company could be used to repay the loans made by the adviser); *In re Global Infrastructure Management, LLC*, Investment Advisers Act Release No. 5930 (Dec. 20, 2021) (settled action) (alleging private fund adviser failed to properly offset management fees to private equity funds it managed and made false and misleading statements to investors and potential investors in those funds concerning management fee offsets); *In the Matter of EDG Management Company, LLC*, Investment Advisers Act Release No. 5617 (Oct. 22, 2020) (settled action) (alleging that private equity fund adviser failed to apply the management fee calculation method specified in the limited partnership agreement by failing to account for write downs of portfolio securities causing the fund and investors to overpay management fees); *In the Matter of Mitchell J. Friedman*, Investment Advisers Act Release No. 5338 (Sept. 4, 2019) (settled action) (alleging that the co-owner of a private fund advisory firm failed to disclose material conflicts of interest to the private fund it managed and misled two investors by misrepresenting an investment opportunity).

<sup>12</sup> See, e.g., *Securities and Exchange Commission v. Philip A. Falcone, Harbinger Capital Partners Offshore Manager, L.L.C. and Harbinger Capital Partners Special Situations GP, L.L.C.*, Civil Action No. 12 Civ. 5027 (PAC) (S.D.N.Y.) and *Securities and Exchange Commission v. and (sic) Harbinger Capital Partners LLC, Philip A. Falcone and Peter A. Jenson*, Civil Action No. 12 Civ. 5028 (PAC) (S.D.N.Y.), Civil Action No. 12 Civ. 5027 (PAC) (S.D.N.Y.), U.S. Securities and Exchange Commission Litigation Release No. 22831A (Oct. 2, 2013) ("Harbinger Capital") (private fund adviser granted favorable redemption and liquidity terms to certain large investors in a private fund without disclosing these arrangements to the fund's board of directors and the other fund investors). See also 17 CFR 275.206(4)–8 (rule 206(4)–8 under the Advisers Act).

disclosures by the fund or the adviser. Ultimately, this information would help investors better understand marketplace dynamics and potentially improve efficiency for future investments, for example, by expediting the process for reviewing and negotiating fees and expenses. More competition and transparency also could lower the costs of capital for portfolio companies raising money and increase returns to investors, potentially bringing greater efficiencies to this part of the capital markets.

We also have continued to observe instances of advisers acting on conflicts of interest that are not transparent to investors, provide substantial financial benefits to the adviser, and potentially have significant negative impacts on the private fund's returns.<sup>13</sup> These issues are widespread in the private fund context because, in many cases, the adviser can influence or control the portfolio company and can extract compensation without the knowledge of the fund or its investors. In addition, private funds typically lack governance mechanisms that would help check overreaching by private fund advisers. For example, although some private funds may have limited partner advisory committees ("LPACs") or boards of directors, these types of bodies may not have the necessary independence, authority, or accountability to oversee and consent to these conflicts or other harmful practices. Private funds also do not have comprehensive mechanisms for private fund investors to exercise effective governance, which is exacerbated by the fact that private fund advisers often provide certain investors with preferential terms that can create potential conflicts among the fund's investors. Moreover, the interests of one or more private fund investors may not represent the interests of, or may otherwise conflict with the interests of, other investors in the private fund due to, among other things, business or personal relationships or other private fund investments. To the extent

investors are afforded governance or similar rights, such as LPAC representation, certain fund agreements permit such investors to exercise their rights in a manner that places their interests ahead of the private fund or the investors as a whole. For example, certain fund agreements state that, subject to applicable law, LPAC members owe no duties to the private fund or to any of the other investors in the private fund and are not obligated to act in the interests of the private fund or the other investors as a whole.

As an example of advisers acting on conflicts of interest, certain venture capital fund advisers use private funds to obtain a controlling or influential interest in a non-publicly traded early stage company and then instruct that company to hire the adviser or its related persons to provide certain services. In these circumstances, the adviser often sets the terms of the engagement, including the price paid for the services. In cases where the adviser causes the fund to overpay for services because the services were not negotiated in an arm's-length process, the adviser's practice of hiring its related persons harms investors by diminishing the private fund's returns. For example, the adviser sometimes instructs the company to pay certain of the adviser's bills, to reimburse the adviser for expenses incurred in managing its investment in the company, or to add to its payroll adviser employees who manage the investment. In contrast, outside of the private fund context, an adviser often uses private fund clients to buy shares in a company and may vote proxies or engage with management and the board, but absent taking some extraordinary steps, the adviser's ability to influence or control the company is generally constrained. In addition, if the company is publicly traded, the adviser's attempts to seize control or make a variety of other changes are generally visible to its clients and the public at large.

Although many conflicts of interest can involve problematic sales practices or compensation schemes, some can be managed. For example, advisers have a conflict of interest with private funds and investors in those funds when they value the fund's assets and use that valuation as the basis for the calculation of the adviser's fees and fund performance.<sup>14</sup> Similarly, advisers or

their related persons have a conflict of interest with the fund and its investors when they offer existing fund investors the option to sell or exchange their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons (an "adviser-led secondary transaction"). In both of these examples, there are opportunities for advisers, funds, and investors to benefit, but there is also a potential for significant harm if the adviser's conflicts are not appropriately handled, including diminishing the fund's returns because of excess fees and expenses paid to the fund's adviser or its related persons. In these cases, enhanced protections in the form of an annual private fund audit and a fairness opinion in connection with an adviser-led secondary transaction would help address the concerns presented by these conflicts.

Other conflicts of interest are contrary to the public interest and the protection of investors, and cannot be managed given the lack of governance mechanisms frequent in private funds as discussed above. For example, we have observed situations where the adviser causes one fund to bear more than its pro rata share of expenses related to a portfolio investment.<sup>15</sup> In these circumstances, an adviser may unfairly allocate fees and expenses to benefit certain favored clients at the expense of others, indirectly benefiting the adviser. Through our examinations, our staff also has encountered instances where advisers seek to limit their fiduciary duty or otherwise provide that the adviser and its related persons will not be liable to the private fund or investors for breaching its duties (including fiduciary duties) or liabilities (that exist at law or in equity).<sup>16</sup> We believe an adviser that seeks to limit its liability in such a manner harms the private fund (and, by extension, the private fund investors) by putting the adviser's interests ahead of the interests of its private fund client.

Accordingly, based on our experience overseeing private fund advisers, as well as private funds' impact on our financial

<sup>13</sup> See, e.g., *In the Matter of Bluecrest Capital Management Limited*, Investment Advisers Act Release No. 5642 (Dec. 8, 2020) (settled action) (alleging that hedge fund adviser strategically re-allocated its best performing personnel (traders) from its flagship hedge fund to its proprietary hedge fund, which followed an overlapping trading strategy and that hedge fund adviser failed to adequately disclose the existence of its proprietary hedge fund, the movement of traders, and related conflicts of interest); *In the Matter of Monomoy Capital Management, L.P.*, Investment Advisers Act Release No. 5485 (Apr. 22, 2020) (settled order) (alleging that private fund adviser charged the fund's portfolio company for the services of its in-house operations group without fully disclosing this practice).

<sup>14</sup> See, e.g., *SEC v. Joseph W. Daniel*, Litigation Release No. 19427 (Oct. 13, 2005) and *In re Joseph W. Daniel*, Investment Advisers Act Release No. 2450 (Nov. 29, 2005) (settled action) (alleging adviser failed to properly value holdings of its hedge fund client, which inflated the management fees investor paid); *In the Matter of Swapnil Rege*,

Investment Advisers Act Release No. 5303 (July 18, 2019) (settled action) (alleging that an employee of a private fund adviser mispriced the private fund's investments, which resulted in the adviser charging the fund excess management fees).

<sup>15</sup> See, e.g., *In the Matter of Lincolnshire Management, Inc.*, Investment Advisers Act Release No. 3927 (Sept. 27, 2014) (settled action) (alleging private equity adviser to two private funds misallocated expenses between the funds).

<sup>16</sup> See, e.g., EXAMS National Examination Program Risk Alert: Observations from Examinations of Private Fund Advisers (Jan. 27, 2022) ("EXAMS Private Funds Risk Alert 2022"), available at <https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf>.

system, our economy, and American investors' savings, there is a need to enhance the regulation of private fund advisers to protect investors, promote more efficient capital markets, and encourage capital formation. The Commission believes that many of the practices it has observed are contrary to the public interest and protection of investors and that these practices, if left unchecked, would continue to harm investors.

In addition, given the lack of strong governance mechanisms at private funds, their compliance programs take on added importance in protecting investors.<sup>17</sup> We are proposing an amendment to the Advisers Act compliance rule to require all SEC-registered advisers, including those that do not manage private funds, to document the annual review of their compliance policies and procedures in writing.<sup>18</sup> Based on staff experience, some investment advisers do not make and preserve written documentation of the annual review of their compliance policies and procedures, which our examination staff relies on to help it understand an adviser's compliance program, determine whether the adviser is complying with the rule, and identify potential weaknesses in the compliance program. Advisers can also rely on written documentation of the annual review to promote an internal culture of compliance and accountability. We believe that requiring written documentation would focus renewed attention on the importance of the annual compliance review process and would result in records of annual compliance reviews that would allow our staff to assess whether an adviser has complied with the review requirement of the compliance rule.

## II. Discussion of Proposed Rules for Private Fund Advisers

We are proposing a series of rules under the Advisers Act that would specifically address these practices by advisers to private funds. The goal of this package of proposed reforms is to protect those who directly or indirectly invest in private funds by increasing visibility into certain practices, establishing requirements to address certain practices that have the potential to lead to investor harm, and prohibiting adviser activity that we believe is contrary to the public interest and the protection of investors. While some of the investor protection concerns identified herein may relate to an adviser's activities with regard to other

client types (e.g., separately managed accounts, pooled vehicles that are not private funds as defined in the Advisers Act), the proposed reforms are designed to address concerns that arise out of the opacity that is prevalent in the private fund structure. We also are proposing corresponding amendments to the books and records requirements in rule 204-2.

We request comment on the following aspects of the package of proposed reforms:

- Are there certain activities that this package of proposed reforms would address in the private fund context that we should also address in other contexts (e.g., separately managed accounts)? Why or why not?
- Are there certain activities in the private fund context that this package of proposed reforms is not addressing but that we should address?

### A. Quarterly Statements

The proposed rule would require an investment adviser that is registered or required to be registered with the Commission to prepare a quarterly statement that includes certain information regarding fees, expenses, and performance for any private fund that it advises and distribute the quarterly statement to the private fund's investors within 45 days after each calendar quarter end, unless a quarterly statement that complies with the proposed rule is prepared and distributed by another person.<sup>19</sup> We believe that periodic statements detailing such information are necessary to improve the quality of information provided to fund investors, allowing them to assess and compare their private fund investments better. This information also would improve their ability to monitor the private fund adviser to ensure compliance with the private fund's governing agreements and disclosures. While private fund advisers may currently provide statements to investors, there is no requirement for advisers to do so under the Advisers Act regulatory regime.

We believe advisers should provide statements to help an investor better understand the relationship between the fees and expenses the investor bears and the performance the investor receives from the investment because of the opaque nature of the fees and expenses typically associated with private fund investments. For example, a private fund's governing documents (e.g., limited partnership agreement, limited liability company agreement, or offering document) may include broad characterizations of the types of

potential fees and expenses. In other cases, the fund's governing documents may give the adviser significant discretion to determine which fees and expenses relate to, and should be borne by, the fund. Examples of broad fee and expense characterizations include "any and all fees and expenses related to the fund's business or activities," "any and all fees and expenses incurred in connection with the operation of the fund," and "any and all fees and expenses that the adviser shall determine to be related to the establishment and operation of the fund." These provisions do not provide investors sufficiently detailed information regarding what fees and expenses will be charged, how much those fees and expenses will be, and how often fees and expenses will be charged.

We believe that periodic statements containing certain required information would allow investors to understand and monitor their private fund investments better. For example, investors could check fees and expenses paid directly or indirectly by the private fund against the private fund's governing documents. This information may allow an investor to identify when the private fund is incorrectly, or improperly, assessed a fee or expense by the adviser contrary to the adviser's fiduciary duty or the fund's governing agreements or disclosures. As discussed in more detail below, the proposed quarterly statement also would improve transparency for investors into both the myriad ways an adviser and its related persons benefit from their relationship with the private fund and the scope of potential conflicts of interests.

In addition, the proposed quarterly statement would allow a private fund investor to compare cost and performance information across its private fund investments. This information would help inform investment decisions, including whether to remain invested in certain private funds or to invest in other private funds managed by the adviser or its related persons. More broadly, this disclosure would help inform investors about the cost and performance dynamics of this marketplace and potentially improve efficiency for future investments. For example, if an investor owns interests in funds with similar investment strategies, the investor may be in a better position to negotiate lower fee rates for future investments because the investor would be aware of the rates charged by certain advisers in that segment of the market.

We recognize that many private fund advisers contractually agree to provide

<sup>17</sup> *Id.*

<sup>18</sup> Proposed rule 206(4)-7(b).

<sup>19</sup> Proposed rule 211(h)(1)-2.

fee, expense, and performance reporting to investors. For example, advisers may provide investors with financial statements, schedules, or other reports regarding the fund and its activities. However, not all private fund investors are able to obtain this information. Others may be able to obtain information, but it may not be sufficiently clear or detailed reporting regarding the costs and performance of a particular private fund. For example, some advisers report only aggregated expenses, or do not provide detailed information about the calculation and implementation of any negotiated rebates, credits, or offsets. Without clear, detailed disclosure, investors are unable to measure and assess the impact fees and expenses have on their investment returns.

Reporting practices also vary across the private funds industry due to, among other things, different forms and templates. Because the proposed requirement of quarterly statements would involve a degree of standardization across the industry, we believe that investors would be able to find and compare key information regarding fees, expenses, and performance for funds with similar characteristics more easily than is the case today. This has the potential to, in our view, bring greater efficiencies to the marketplace by improving investor decision making. For example, investors likely would be able to compare adviser compensation across similar funds, which may assist investors in determining whether to negotiate or renegotiate economic terms or whether to invest or continue to invest in private funds managed by the adviser.

The proposed quarterly statement requirement would provide fund-wide reporting. We believe this approach would help private fund investors compare the costs of investing across private funds. We are not proposing to require private fund advisers to provide personalized account statements showing each individual investor's fees, expenses, and performance. The proposed quarterly statements are designed, in part, to allow individual private fund investors to use fund-level information to perform more personal, customized calculations. In addition, these proposed requirements do not prevent an adviser from providing (or causing a third party, such as an administrator, consultant, or other service provider, to provide), or an investor from negotiating, personalized reporting. In the registered fund context, fund-level reporting has, in our view, enabled retail investors to understand their investments better. We believe a

comparable approach, but one that is more suitable to the needs of investors in private funds, is appropriate here.

We request comment on the following aspects of the proposed rule:

- Should we, as proposed, require advisers to private funds to prepare a quarterly statement providing standardized disclosures regarding the cost of investing in the private fund and the private fund's performance and distribute the quarterly statement to the fund's investors? Should we instead require advisers to provide investors with personalized information that takes into account the investors' individual ownership stake in the fund in addition to, or in lieu of, a statement covering the private fund? If so, what information should be included in the personalized disclosure? For example, should the statement reflect specific fee arrangements, including any offsets or waivers applicable only to the investors receiving the statement? Do advisers currently provide personalized fee, expense, and performance disclosures? If so, what other types of information do advisers or funds typically include? Do they automate such disclosures? How expensive and complex would it be for advisers to create and deliver personalized disclosures? How useful would it be for investors to receive personalized disclosures?

- Would investors find data regarding the private fund's fees, expenses, and performance useful given that certain investors may have different economic arrangements with the adviser, such as fee breaks or expense caps? Should we require advisers to disclose in the quarterly statement whether investors are subject to different economic arrangements, whether documented in side letters or other written agreements or, to the extent applicable, as a result of different class terms? If so, should we require advisers to list the rates or otherwise show a range?

- Should the quarterly statement rule apply to registered advisers to private funds as proposed or should it apply to all advisers to private funds? Should it apply to exempt reporting advisers? Should the rule include any exceptions for categories of advisers? If so, what conditions should apply to such an exception?

- Should the rule require advisers to prepare and distribute the quarterly statements only to private fund investors, as proposed? Alternatively, should the rule require advisers to provide quarterly statements to investors in other types of pooled investment vehicles, such as a vehicle that relies on an exclusion from the definition of "investment company" in

section 3 of the Investment Company Act other than section 3(c)(1) or 3(c)(7) of that Act? For example, should we require advisers to provide quarterly statements to investors in pooled investment vehicles that rely on the exclusion from the definition of "investment company" in section 3(c)(5)(C) of that Act?<sup>20</sup>

- The proposed rule would require an adviser to distribute the quarterly statement to the private fund's investors within 45 days after each calendar quarter end, unless such a quarterly statement is prepared and distributed by another person. Would this provision eliminate burdens where there are multiple advisers to the same fund, while still providing the fund's investors with the benefits of the quarterly statement? Would the fund's primary adviser typically prepare and distribute the quarterly statement in these circumstances? How would advisers that do not prepare and distribute a quarterly statement in reliance on another adviser demonstrate compliance with this requirement?

- The proposed rule would require advisers to prepare and distribute a quarterly statement disclosing certain information regarding a private fund's fees, expenses, and performance. Are there alternative approaches we should require to improve investor protection and bring greater efficiencies to the market? For example, should we establish maximum fees that advisers may charge at the fund level? Should we prohibit certain compensation arrangements, such as the "2 and 20" model? Should we prohibit advisers from receiving compensation from portfolio investments to the extent they also receive management fees from the fund? Should we require advisers to disclose their anticipated management fee revenue and operating budget to private fund investors or an LPAC or other similar body (despite the limitations of private fund governance mechanisms, as discussed above) on an annual or more frequent basis? Should we impose limitations on management fees (which are typically paid regardless of whether the fund generates a profit), but not impose limitations on performance-based compensation (which is typically tied to the success of the fund)? Should we prohibit

<sup>20</sup> Section 3(c)(5)(C) of the Investment Company Act provides an exclusion from the definition of investment company for any person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.

management fees from being charged as a percentage of committed capital and instead only permit management fees to be based on invested capital, net asset value, and other similar types of fee bases? Should we prohibit certain expense practices or arrangements, such as expense caps provided to certain, but not all, investors?

- Similarly, should we prohibit certain types of private fund performance information in the quarterly statement? For example, should we prohibit advisers from presenting performance with the impact of fund-level subscription facilities? Should we prohibit advisers from presenting combined performance for multiple funds, such as a main fund and a co-investment fund that pays lower or no fees?

- Do private fund advisers or their related persons receive other economic benefits that the rule should require advisers to disclose in the quarterly statement? For example, should the quarterly statement also require disclosure and quantification of the kinds of economic benefits commonly received by advisers or their related persons from broker-dealers or other service providers to private funds, such as hedge funds? Why or why not?

#### 1. Fee and Expense Disclosure

The proposed rule would require an investment adviser that is registered or required to be registered to prepare and distribute quarterly statements with certain information regarding fees and expenses, including fees and expenses paid by underlying portfolio investments to the adviser or its related persons. While the types of fees and expenses charged to private funds can vary across the industry, private funds are often more expensive than other asset classes because the scope and magnitude of fees and expenses paid directly and indirectly by private fund investors can be extensive. Investors typically compensate the adviser for managing the affairs of the fund, often in the form of management fees.<sup>21</sup> On top of that, investors typically pay or otherwise bear performance-based compensation.<sup>22</sup> A fund's portfolio

investments also may pay fees to the adviser or its related persons. For example, principals of the adviser may receive cash or non-cash compensation—such as equity awards or stock options—for serving as directors of a portfolio investment owned by the private fund. Portfolio investment compensation is typically in addition to compensation paid or allocated to the adviser or its related persons at the fund level, unless the fund's governing documents require the adviser to offset portfolio investment compensation against other revenue streams or otherwise provide a rebate to investors. Compensation at the “portfolio investment-level” is more common for certain private funds—such as private equity funds or real estate funds—and less common for others—such as hedge funds.

Investors generally are required to bear all expenses related to the operation of the fund and its portfolio investments. In addition to expenses such as organizational and offering expenses, private fund investors also frequently bear expenses that vary based on the private fund's strategy and contractual agreements. For example, hedge fund investors indirectly bear trading expenses. Investors in private equity and venture capital funds indirectly bear expenses associated with fund investments, such as deal sourcing and due diligence expenses, including for investments that are unconsummated. Investors in private funds with a real estate investment strategy also indirectly bear expenses related to property management, environmental reviews, and site inspections. These expenses generally are uncapped, and, unlike a fund's performance-based compensation, private fund investors are typically required to bear them regardless of whether the fund or the applicable investment generates a positive return for investors.

Investors often lack transparency regarding the total cost of such fees and expenses.<sup>23</sup> For example, even though investors indirectly bear the costs

associated with a portfolio investment paying fees to the adviser or its related persons, advisers often do not disclose the magnitude or scope of these fees to investors. Opaque reporting practices make it difficult for investors to measure and evaluate performance accurately and to make informed investment decisions.<sup>24</sup> Moreover, such reporting practices may prevent private fund investors from assessing whether the type and amount of fees and expenses borne by the private fund comply with the fund's governing agreements and can lead to problematic compensation schemes and sales practices with investors bearing excess or improper fees and expenses. The Commission has brought enforcement actions related to the disclosure and allocation of fees and expenses by private fund advisers. For example, we have alleged in settled enforcement actions that advisers have received undisclosed fees,<sup>25</sup> improperly shifted expenses away from the adviser,<sup>26</sup> and misallocated fees and expenses among private fund clients.<sup>27</sup> Staff has observed similarly problematic compensation schemes and sales practices in its examinations of private fund advisers.<sup>28</sup> For example, staff has observed advisers that charge private funds for expenses not permitted under the fund documents. Staff has also observed advisers improperly allocate shared expenses, such as broken-deal, due diligence, and consultant expenses, among private fund clients and their own accounts.

We have seen a significant increase in investors seeking transparency regarding fees and expenses. For example, certain investors and industry groups have encouraged advisers to adopt uniform reporting templates to promote transparency and alignment of interests between advisers and

<sup>24</sup> See, e.g., Letter from State Treasurers and Comptrollers to Mary Jo White, U.S. Securities & Exchange Commission (July 21, 2015), available at [http://comptroller.nyc.gov/wp-content/uploads/documents/SEC\\_SignOnPDF.pdf](http://comptroller.nyc.gov/wp-content/uploads/documents/SEC_SignOnPDF.pdf); see also Letter from Americans for Financial Reform Education Fund to Chairman Gary Gensler, U.S. Securities & Exch. Commission (July 6, 2021), available at <https://ourfinancialsecurity.org/wp-content/uploads/2021/07/Letter-to-SEC-re-Private-Equity-7.6.21.pdf>.

<sup>25</sup> See, e.g., *In the Matter of Blackstone Management Partners, L.L.C.*, et. al., Investment Advisers Act Release No. 4219 (Oct. 7, 2015) (settled action).

<sup>26</sup> See, e.g., *In the Matter of Cherokee Investment Partners, LLC and Cherokee Advisers, LLC*, Investment Advisers Act Release No. 4258 (Nov. 5, 2015) (settled action).

<sup>27</sup> See, e.g., *In the Matter of Lincolnshire Management, Inc.*, Investment Advisers Act Release No. 3927 (Sept. 22, 2014) (settled action).

<sup>28</sup> See EXAMS Private Funds Risk Alert 2020, *supra* footnote 9.

<sup>21</sup> Certain private fund advisers utilize a pass-through expense model where the private fund pays for most, if not all, expenses, including the adviser's expenses, but the adviser does not charge a management fee. See *infra* section II.D.2. for a discussion of such pass-through expense models.

<sup>22</sup> Investors typically enter into agreements under which the private fund pays such compensation directly to the adviser or its affiliates. Investors generally bear such compensation indirectly through their investment in the private fund; however, certain agreements may require investors to pay the adviser directly.

<sup>23</sup> See Hedge Fund Transparency: Cutting Through the Black Box, The Hedge Fund Journal, James R. Hedges IV (Oct. 2006) (stating that “the biggest challenges facing today's hedge fund industry may well be the issues of transparency and disclosure”), available at <https://thehedgefundjournal.com/hedge-fund-transparency/>; Fees & Expenses, Private Funds CFO (Nov. 2020) at 12 (noting that it is becoming increasingly complicated for investors to determine what the management fee covers versus what is a partnership expense and stating that the “formulas for management fees are complex and unique to different investors.”), available at <https://www.troutman.com/images/content/2/6/269858/PFCFO-FeesExpenses-Nov20-Final.pdf>.



investors.<sup>29</sup> Despite these efforts, many advisers still do not voluntarily provide adequate disclosure to investors. The proposed quarterly statement rule would mandate them to provide it.

#### a. Private Fund-Level Disclosure

The proposed quarterly statement rule would require private fund advisers to disclose the following information to investors in a table format:

(1) A detailed accounting of all compensation, fees, and other amounts allocated or paid to the adviser or any of its related persons by the private fund during the reporting period (“adviser compensation”);

(2) A detailed accounting of all fees and expenses paid by the private fund during the reporting period other than those listed in paragraph (1) above (“fund expenses”); and

(3) The amount of any offsets or rebates carried forward during the reporting period to subsequent quarterly periods to reduce future payments or allocations to the adviser or its related persons.<sup>30</sup>

The table would provide investors with comprehensive fee and expense disclosure for the prior quarterly period (or, in the case of a newly formed private fund’s initial quarterly statement, its first two full calendar quarters of operating results).<sup>31</sup> We will discuss each of these elements in turn.

**Adviser Compensation.** The proposed rule would require the fund table to show a detailed accounting of all adviser compensation during the reporting period, with separate line items for each category of allocation or payment reflecting the total dollar amount.<sup>32</sup> The proposed rule is designed to capture all compensation, fees, and other amounts allocated or paid to the investment adviser or any of

its related persons by the fund, including, but not limited to, management, advisory, sub-advisory, or similar fees or payments, and performance-based compensation.<sup>33</sup>

We believe requiring advisers to disclose all forms of adviser compensation as separate line items (without prescribing particular categories of fees) is appropriate because it would encompass the various forms of adviser compensation across the private funds industry. Many private funds compensate advisers with a “2 and 20” arrangement, consisting of a 2% management fee and a 20% share of any profits generated by the fund. Certain advisers, however, receive other forms of compensation from private funds in addition to, or in lieu of, such amounts. For example, certain advisers charge private funds administration fees or servicing fees. The proposal would help ensure disclosure of the various forms of adviser compensation, and the corresponding dollar amounts of each type of compensation, to current investors regardless of how an adviser characterizes the compensation and regardless of the different economic arrangements in place. This would allow investors to understand and assess the magnitude and scope of adviser compensation better and help validate that adviser compensation conforms to contractual agreements.

In addition to compensation paid to the adviser, the proposed rule would require disclosure of compensation, fees, and other amounts allocated or paid to the adviser’s “related persons.” We propose to define “related persons” to include: (i) All officers, partners, or directors (or any person performing similar functions) of the adviser; (ii) all persons directly or indirectly controlling or controlled by the adviser; (iii) all current employees (other than employees performing only clerical, administrative, support or similar functions) of the adviser; and (iv) any person under common control with the adviser.<sup>34</sup> The term “control” would be

defined to mean the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise.<sup>35</sup>

Many advisers conduct a single advisory business through multiple separate legal entities or provide services to a private fund through different affiliated entities. The proposed “related person” definition is designed to capture the various entities and personnel an adviser may use to provide advisory services to, and receive compensation from, private fund clients. We considered, but are not proposing, a broader definition of related persons to include additional entities related to the adviser or its personnel, such as entities the adviser or its personnel own a financial interest in but do not control. We are not proposing a broader definition because it would likely capture entities or persons outside of the ones advisers typically use to conduct a single advisory business. In addition, the proposed definition is consistent with the definition of related person used on Form ADV, which advisers have experience assessing as part of their disclosure obligations on that form. We believe that the proposed definition captures the relevant entities without being overly broad.

**Fund Fees and Expenses.** The proposed rule would also require the fund table to show a detailed accounting of all fees and expenses paid by the private fund during the reporting period, other than those disclosed as adviser compensation, with separate line items for each category of fee or

by defining related person to include any person, directly or indirectly, controlling or controlled by the adviser, and any person that is under common control with the adviser.

<sup>35</sup> Proposed rule 211(h)(1)–1. The definition, in addition, provides that (i) each of an investment adviser’s officers, partners, or directors exercising executive responsibility (or persons having similar status or functions) is presumed to control the investment adviser; (ii) a person is presumed to control a corporation if the person: (A) Directly or indirectly has the right to vote 25% or more of a class of the corporation’s voting securities; or (B) has the power to sell or direct the sale of 25% or more of a class of the corporation’s voting securities; (iii) a person is presumed to control a partnership if the person has the right to receive upon dissolution, or has contributed, 25% or more of the capital of the partnership; (iv) a person is presumed to control a limited liability company if the person: (A) Directly or indirectly has the right to vote 25% or more of a class of the interests of the limited liability company; (B) has the right to receive upon dissolution, or has contributed, 25% or more of the capital of the limited liability company; or (C) is an elected manager of the limited liability company; or (v) a person is presumed to control a trust if the person is a trustee or managing agent of the trust. Form ADV also uses the same definition.

<sup>29</sup> See, e.g., Institutional Limited Partners Association (“ILPA”) Reporting Template, available at <https://ilpa.org/reporting-template/stating> that, since its release, more than one hundred and forty organizations have endorsed the ILPA reporting template, including more than twenty advisers).

<sup>30</sup> Proposed rule 211(h)(1)–2(b).

<sup>31</sup> See proposed rule 211(h)(1)–1 (defining “reporting period” as the private fund’s calendar quarter covered by the quarterly statement or, for the initial quarterly statement of a newly formed private fund, the period covering the private fund’s first two full calendar quarters of operating results). To the extent a newly formed private fund begins generating operating results on a day other than the first day of a calendar quarter (e.g., January 1), the adviser should include such partial quarter and the immediately succeeding calendar quarters in the newly formed private fund’s initial quarterly statement. For example, if a fund begins generating operating results on February 1, the reporting period for the initial quarterly statement would cover the period beginning on February 1 and ending on September 30.

<sup>32</sup> Proposed rule 211(h)(1)–2(b)(1).

<sup>33</sup> We propose to define “performance-based compensation” as allocations, payments, or distributions of capital based on the private fund’s (or its portfolio investments’) capital gains and/or capital appreciation. This definition’s scope is broad and includes cash or non-cash compensation, including, for example, in-kind allocations, payments, or distributions of performance-based compensation. We believe that the broad scope of the definition, which would capture, without limitation, carried interest, incentive fees, incentive allocations, or profit allocations, among other forms of compensation, is appropriate given the various forms and types of performance-based compensation across the private funds industry.

<sup>34</sup> Proposed rule 211(h)(1)–1. Form ADV also uses the same definition. The regulations at 17 CFR 275.206(4)–2 (rule 206(4)–2) use a similar definition



expense reflecting the total dollar amount.<sup>36</sup> Similar to the approach taken with respect to adviser compensation discussed above, the proposed rule would capture all fund fees and expenses paid during the reporting period including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel expenses.

We have observed two general trends in the private funds industry that support this approach. First, fund expenses have risen significantly in recent years for certain private funds due to, among other things, complex fund structures, global marketing and investment efforts, and increased service provider costs.<sup>37</sup> Advisers often pass on such increases to the private funds they advise, without providing investors with detailed disclosure about the magnitude or type of expenses actually charged to the fund. Second, certain advisers have shifted expenses related to their advisory business to private fund clients.<sup>38</sup> For example, some advisers charge private fund clients for salaries and benefits related to personnel of the adviser. Such expenses historically have been paid by advisers with management fee proceeds or other revenue streams, but are increasingly being charged as separate expenses that may not be transparent to fund investors.<sup>39</sup>

The proposed quarterly statement rule would require a detailed accounting of each category of fund expense. This would require advisers to list each specific category of expense as a separate line item, rather than permit advisers to group fund expenses into broad categories. For example, if a fund paid insurance premiums, administrator expenses, and audit fees during the reporting period, a general reference to “fund expenses” on the quarterly statement would not satisfy the detailed accounting requirement. Instead, an adviser would be required to list each specific category of expense (*i.e.*,

insurance premiums, administrator expenses, and audit fees), and the corresponding dollar amount, separately. As with adviser compensation, we believe this approach would provide private fund investors with sufficient detail to validate that the fund expenses borne by the fund conform to contractual agreements.

To the extent a fund expense also could be characterized as adviser compensation under the proposed rule, the proposed rule would require advisers to disclose such payment or allocation as adviser compensation and not as a fund expense in the quarterly statement. For example, certain private funds may engage the adviser or its related persons to provide services to the fund, such as consulting, legal, or back-office services. An adviser would disclose any compensation, fees, or other amounts allocated or paid by the fund for such services as part of the detailed accounting of adviser compensation. This approach would help ensure that investors understand the entire amount of adviser compensation allocated or paid to the adviser and its related persons during the reporting period.

*Offsets, Rebates, and Waivers.* We are proposing to require advisers to disclose adviser compensation and fund expenses in the fund table both before and after the application of any offsets, rebates, or waivers.<sup>40</sup> Specifically, the proposed rule would require an adviser to present the dollar amount of each category of adviser compensation or fund expense before and after any such reduction for the reporting period.

Advisers may offset, rebate, or waive adviser compensation or fund expenses in a number of circumstances. For example, a private equity adviser may enter into a management services agreement with a fund’s portfolio company, requiring the company to pay the adviser a fee for those services. To the extent the fund’s governing agreement requires the adviser to share the fee with the fund investors through an offset to the management fee, the management fee would typically be reduced, on a dollar-for-dollar basis, by an amount equal to the fee.<sup>41</sup> Under the proposed rule, the adviser would be required to list the management fee both before and after the application of the fee offset.<sup>42</sup>

<sup>40</sup> Proposed rule 211(h)(1)–2(b).

<sup>41</sup> The offset shifts some or all of the economic benefit of the fee from the adviser to the private fund investors.

<sup>42</sup> Offsets, rebates, and waivers applicable to certain, but not all, investors through one or more separate arrangements would be required to be reflected and described prominently in the fund-

We considered whether to require advisers to disclose adviser compensation and fund expenses only after the application of offsets, rebates, and waivers, rather than before and after. We recognize that investors may find the reduced numbers more meaningful, given that they generally reflect the actual amounts borne by the fund during the reporting period. We believe, however, that presenting both figures would provide investors with greater transparency into advisers’ fee and expense practices, particularly with respect to how offsets, rebates, and waivers affect adviser compensation. Transparency into fee and expense practices is important because it would assist investors in monitoring their private fund investments and, for certain investors, would ease their own efforts at complying with their reporting obligations.<sup>43</sup> We also believe that advisers would have this information readily available and both sets of figures would be helpful to investors in monitoring whether and how offsets, rebates, and waivers are applied.

In addition, we are proposing to require advisers to disclose the amount of any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future adviser compensation.<sup>44</sup> This information would allow investors to understand whether they are or the fund is entitled to additional reductions in future periods.<sup>45</sup> Further, we believe that this information would assist investors with their liquidity management and cash flow models, as they would have greater insight into the fund’s projected cash flows and their obligations to satisfy future capital calls for adviser compensation with cash on hand.

We request comment on all aspects of the proposed content of the fund fee and expense table, including the following items:

- Should we require advisers to disclose all compensation and fund expenses as proposed? Do commenters

wide numbers presented in the quarterly statement. See proposed rule 211(h)(1)–2(d) and (g).

<sup>43</sup> For example, certain investors, such as U.S. state pension plans, may be required to report complete information regarding fees and expenses paid to the adviser and its related persons.

<sup>44</sup> Proposed rule 211(h)(1)–2(b)(3).

<sup>45</sup> To the extent advisers are required to offset fund-level compensation (*e.g.*, management fees) by portfolio investment compensation (*e.g.*, monitoring fees), they typically do not reduce adviser compensation below zero, meaning that, in the event the monitoring fee offset amount exceeds the management fee for the applicable period, some fund documents provide for “carryforwards” of the unused amount. The carryforwards are used to offset the management fee in subsequent periods.

<sup>36</sup> Proposed rule 211(h)(1)–2(b)(2).

<sup>37</sup> See, *e.g.*, Coming to Terms: Private Equity Investors Face Rising Costs, Extra Fees (Dec. 20, 2021), available at [https://www.wsj.com/articles/coming-to-terms-private-equity-investors-face-rising-costs-extra-fees-11640001604#:~:text=Coming%20to%20Terms%3A%20Private-Equity%20Investors%20Face%20Rising%20Costs%2C,and%20some%20expenses%20are%20excluded%20from%20annual%20fees.](https://www.wsj.com/articles/coming-to-terms-private-equity-investors-face-rising-costs-extra-fees-11640001604#:~:text=Coming%20to%20Terms%3A%20Private-Equity%20Investors%20Face%20Rising%20Costs%2C,and%20some%20expenses%20are%20excluded%20from%20annual%20fees.;); Key Findings ILPA Industry Intelligence Report “What is Market in Fund Terms?” (2021) (“ILPA Key Findings Report”), available at <https://ilpa.org/wp-content/uploads/2021/10/Key-Findings-Industry-Intelligence-Report-Fund-Terms.pdf>.

<sup>38</sup> Such practice is often not disclosed, or not fully disclosed, in private fund documents.

<sup>39</sup> See ILPA Key Findings Report, *supra* footnote 37.

agree with the scope of the proposal? Why or why not?

- Would the proposed content result in fund-level fee and expense disclosure that is meaningful to investors? Are there other items that advisers should be required to disclose in the fund table? Are there any proposed items that we should eliminate? Would more or less information about the fees and expenses charged to the fund be helpful for investors? Are there any revisions to the descriptions of fees that would make the proposed disclosure more useful to investors?

- Instead of the proposed approach, should we prescribe a template for the fund table? Would the increased comparability of a template be useful to investors? Would a template be flexible enough to accommodate changes in the types of fees and expenses as well as the types of offsets, rebates, or waivers used by private fund advisers? Would a template necessitate repeated updating as the industry evolves?

- Should we include any additional definitions of terms or phrases for the fund table? Should we omit any definitions we have proposed for the fund table?

- The proposed rule would require an adviser to include the compensation paid to a related person sub-adviser in its quarterly statement. For private funds that have sub-advisers that are not related persons, should we require a single quarterly statement showing all adviser compensation (at both the adviser and sub-adviser levels)? In cases where a non-related person sub-adviser does not prepare a quarterly account statement in reliance on the adviser's preparation and distribution of the quarterly statement to the fund's investors, how would advisers reflect the compensation paid to the sub-adviser and its related persons? Do commenters agree that such compensation would be captured as a fund expense? Should we require a separate table covering these fees and expenses, as well as a separate table showing portfolio investment compensation paid to the sub-adviser or its related person? How would advisers operationalize this requirement in these circumstances?

- Should we adopt the proposed definitions of "related persons" and "control" as proposed? Are they too broad? Are the proposed definitions broad enough? Should we add former personnel of the adviser or its related persons to the proposed definition? If so, for how long after a departure from the adviser or its related persons should such personnel fall into the definition? Should the definition of related person

include family members of adviser personnel or persons who share the same household with adviser personnel? Should the definition capture any person directly or indirectly controlled by the adviser's officers, partners, or directors (including any consulting firms controlled by such persons)? Should it capture operational partners, senior advisors, or other similar consultants of the adviser, the private fund, or its portfolio investments? Should we add any entity more than five percent of the ownership of which is held, directly or indirectly, by the adviser or its personnel? Should the definition include any person that receives, directly or indirectly, management fees or performance based compensation from, or in respect of, the fund; or any person that has an interest in the investment adviser or general partner (or similar control person) of the fund? If we adopt a different definition of "related person" than what is being proposed, should we use a different defined term (such as "related party") to avoid confusion given that the term "related person" is defined in Form ADV?

- For purposes of the definition of "control," are the control presumptions appropriate in this context? Should we eliminate or modify any of the presumptions? For example, should we eliminate aspects of the definition that may capture passive investors who do not have the power to direct the management or policies of the relevant entity? Why or why not? Should we add any additional control presumptions? For example, should an entity be presumed to be controlled by an adviser to the extent the adviser has authority over the entity's budget or whether to hire personnel or terminate their employment?

- The proposed rule includes a non-exhaustive list of certain types of adviser compensation and fund expenses.<sup>46</sup> Would this information assist advisers in complying with the rule? Should we add any additional types? If so, which ones and why?

- Do private fund advisers or their related persons receive other economic benefits that the rule should require advisers to disclose in the quarterly statement? For example, should we require hedge fund advisers to disclose

the dollar amount of any soft dollar or similar benefits provided by broker-dealers that execute trades for the funds, or any benefits provided by hedge fund prime brokers?

- Do commenters agree with the scope of the proposed definition of "performance-based compensation"? Should we specify the types of compensation that should be included in the definition? For example, should the definition specify that the term includes carried interest, incentive fees, incentive allocations, performance fees, or profit allocations?

- Should we only require the table to disclose adviser compensation and fund expenses after the application of any offsets, rebates, or waivers, rather than before and after, as proposed? If so, why?

- Should we define offsets, rebates, and waivers? If so, what definitions should we use and why? Are there any types of offsets, rebates, and waivers that we should not require advisers to reflect in the fund table? If so, which ones and why? To the extent that offsets, rebates, or waivers are available to certain, but not all, investors, are there any operational concerns with reflecting and describing those offsets, rebates, or waivers in the fund-wide numbers presented in the quarterly statement? Are there alternatives we should use?

- Should we require advisers to disclose the amount of any offsets or rebates carried forward during the reporting period to subsequent periods to reduce future adviser compensation as proposed? Would this information be helpful for investors? Do advisers already provide this information in the fund's financial statements or otherwise?

- Should we require advisers to provide any additional disclosures regarding fees and expenses in the quarterly statement? In particular, should we require any disclosures from an investment adviser's Form ADV Part 2A narrative brochure (if applicable) to be included in the quarterly statement, such as more details about an investment adviser's fees?

- Should we tailor the disclosure requirements based on fund type? For example, should the requirements or format for hedge funds differ from the requirements and format for private equity funds? Are there unique fees or expenses for types of funds that advisers should be required to disclose or otherwise list as a separate line item? If so, how should we define these types of funds for these purposes? For example, should we use the definitions of such terms used on Form ADV?

<sup>46</sup> Proposed rule 211(h)(1)–2(b)(1) includes the following non-exhaustive list of adviser compensation: Management, advisory, sub-advisory, or similar fees or payments, and performance-based compensation. Proposed rule 211(h)(1)–2(b)(2) includes the following non-exhaustive list of fund expenses: Organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses.

- Do any of the proposed requirements impose unnecessary costs or compliance challenges? Please provide specific data. Are there any modifications to the proposal that we could make that would lower those costs or mitigate those challenges? Please provide examples.

- The proposed quarterly statement prescribes minimum fee and expense information that must be included. What are the benefits and drawbacks of prescribing the minimum disclosure to be included in the quarterly statement and otherwise permitting advisers to include additional information? Do commenters agree that we should allow advisers to include additional information? Would the inclusion of additional information affect whether investors review the quarterly statement?

- Certain advisers use management fee waivers where the amount of management fees paid by the fund to the adviser is reduced in exchange for an increased interest in fund profits.<sup>47</sup> Because fund agreements often document such waivers with complex and highly technical tax provisions, should we provide guidance to assist advisers in complying with the proposed requirement to describe the manner in which they are calculated or specify a methodology for such calculations?

- Should we permit advisers to exclude expenses from the quarterly statement if they are below a certain threshold? Alternatively, should we permit advisers to group expenses into broad categories and disclose them under single line item—such as “Miscellaneous Expenses” or “Other Expenses”—if the aggregate amount is *de minimis* relative to the fund’s size? Why or why not?

- The proposed rule would require the initial quarterly statement for newly formed funds to include start-up and organizational fees of the fund if they were paid during the reporting period. Instead, should the proposed rule exclude those fees and expenses?

- Should the table provide fee and expense information for any other periods? For example, should we require advisers to disclose all adviser compensation and fund expenses since inception (in addition to adviser compensation and fund expenses allocated or paid during the applicable reporting period)? If so, should we require since-inception information

only for certain types of funds, such as closed-end private funds, and not for other types of funds, such as open-end private funds?

- We recognize that certain private fund advisers may already provide quarterly account or similar statements to investors, such as advisers that rely on an exemption from certain disclosure and recordkeeping requirements provided by U.S. Commodity Futures Trading Commission regulations at 17 CFR 4.7. How often are private fund advisers separately required to provide such quarterly statements, and how often do they do so even when not required? Would there be any overlap between the proposed quarterly statement and the existing quarterly account or similar statements currently prepared by advisers?

#### b. Portfolio Investment-Level Disclosure

The proposed quarterly statement rule would require advisers to disclose the following information with respect to any covered portfolio investment,<sup>48</sup> in a single table covering all such covered portfolio investments:

(1) A detailed accounting of all portfolio investment compensation allocated or paid by each covered portfolio investment during the reporting period;<sup>49</sup> and

(2) The private fund’s ownership percentage of each such covered portfolio investment as of the end of the reporting period or, if the fund does not have an ownership interest in the covered portfolio investment, the adviser would be required to list zero percent as the fund’s ownership percentage along with a brief description of the fund’s investment in such covered portfolio investment.<sup>50</sup>

The proposed rule defines “portfolio investment” as any entity or issuer in which the private fund has invested directly or indirectly.<sup>51</sup> This definition is designed to capture any entity or issuer in which the private fund holds an investment including through holding companies, subsidiaries, acquisition vehicles, special purpose vehicles, and other vehicles through which investments are made or

otherwise held by the private fund.<sup>52</sup> As a result, the proposed definition may capture more than one entity or issuer with respect to any single investment made by a private fund. For example, if a private fund invests directly in a holding company that owns two subsidiaries, the proposed definition would capture all three entities. Depending on a private fund’s underlying investment structure, an adviser may have to determine, in good faith, which entity or entities constitute the portfolio investment under the proposed rule.

We considered, but are not proposing, using the term “portfolio company,” rather than “portfolio investment.” We believe that the term “portfolio company” would be too narrow given that some private funds do not invest in traditional operating companies. For example, certain private funds originate loans and invest in credit-related instruments, while others invest in more bespoke assets such as music royalties, aircraft, and tanker vessels. The proposed rule would define “portfolio investment” to apply to all types of private fund investments and structures. The proposed definition also is designed to remain evergreen, capturing new investment structures as they continue to evolve.

We recognize, however, that portfolio investments of certain private funds may not pay or allocate portfolio-investment compensation to an adviser or its related persons. For example, advisers to hedge funds focusing on passive investments in public companies may be less likely to receive portfolio-investment compensation than advisers to private equity funds focusing on control-oriented investments in private companies. Under the proposed rule, advisers would only be required to disclose information regarding *covered portfolio investments*, which we propose to define as portfolio investments that allocated or paid the investment adviser or its related persons portfolio investment compensation during the reporting period.<sup>53</sup> We

<sup>52</sup> Certain investment strategies can involve complex transactions and the use of negotiated instruments or contracts, such as derivatives, with counterparties. Although such trading involves a risk that a counterparty will not settle a transaction or otherwise fail to perform its obligations under the instrument or contract and thus result in losses to the fund, we would generally not consider the fund to have made an investment in the counterparty in this context. We believe this approach is appropriate because any gain or loss from the investment generally would be tied to the performance of the derivative and the underlying reference security, rather than the performance of the counterparty.

<sup>53</sup> See proposed rule 211(h)(1)–1 (defining “covered portfolio investment”).

<sup>47</sup> Management fee waiver arrangements often provide certain economic benefits for the adviser, such as the possibility of reducing and/or deferring certain tax obligations.

<sup>48</sup> See proposed rule 211(h)(1)–1 (defining “covered portfolio investment” as a portfolio investment that allocated or paid the investment adviser or its related persons portfolio investment compensation during the reporting period).

<sup>49</sup> See proposed rule 211(h)(1)–1 (defining “portfolio investment compensation” as any compensation, fees, and other amounts allocated or paid to the investment adviser or any of its related persons by the portfolio investment attributable to the private fund’s interest in such portfolio investment).

<sup>50</sup> Proposed rule 211(h)(1)–2(c).

<sup>51</sup> Proposed rule 211(h)(1)–1.

believe this approach is appropriate because the portfolio investment table is designed to highlight the scope and magnitude of any investment-level compensation as well as to improve transparency for investors into the potential conflicts of interest of the adviser and its related persons. If an adviser does not receive such compensation, we do not believe the adviser should have such a reporting obligation. Accordingly, the proposed rule would not require advisers to list any information regarding portfolio investments that do not fall within the *covered portfolio investment* definition for the applicable reporting period. These advisers, however, would need to identify portfolio investment payments and allocations in order to know whether they must provide the disclosures under this requirement.

**Portfolio Investment Compensation.** The proposed rule would require the portfolio investment table to show a detailed accounting of all portfolio investment compensation allocated or paid by each covered portfolio investment during the reporting period, with separate line items for each category of allocation of payment reflecting the total dollar amount, including (though it is not limited to) origination, management, consulting, monitoring, servicing, transaction, administrative, advisory, closing, disposition, directors, trustees or similar fees or payments by the covered portfolio investment to the investment adviser or any of its related persons. An adviser should disclose the identity of each covered portfolio investment to the extent necessary for an investor to understand the nature of the conflicts associated with such payments.

Similar to the approach taken with respect to adviser compensation and fund expenses discussed above, the proposed rule would require a detailed accounting of *all* portfolio investment compensation paid or allocated to the adviser and its related persons.<sup>54</sup> This would require advisers to list each specific type of portfolio investment compensation, and the corresponding dollar amount, as a separate line item. We believe that this approach is appropriate given that portfolio investment compensation can take many different forms and often varies based on fund type. For example, portfolio investments of private credit funds may pay the adviser a servicing fee for managing a pool of loans held

directly or indirectly by the fund. Portfolio investments of private real estate funds may pay the adviser a property management fee or a mortgage-servicing fee for managing the real estate investments held directly or indirectly by the fund.

We believe that this disclosure would inform investors about the scope of portfolio investment compensation paid to the adviser and related persons, and could help provide insight into some of the conflicts of interest some advisers face. For example, in cases where the adviser controls the portfolio investment, the adviser also generally has discretion over whether to charge portfolio investment compensation and, if so, the rate, timing, method, amount, and recipient of such compensation. Additionally, where the private fund's governing documents require the adviser to offset portfolio investment compensation against other revenue streams or otherwise provide a rebate to investors, this information would also help investors monitor the application of such offsets or rebates.

The proposed rule would require the adviser to disclose the amount of portfolio investment compensation attributable to the private fund's interest in the covered portfolio investment.<sup>55</sup> Such amount would not reflect the portion attributable to any other person's interest in the covered portfolio investment. For example, if the private fund and another person co-invested in the same portfolio investment and the portfolio investment paid the private fund's adviser a monitoring fee, the table would only list the total dollar amount of the monitoring fee attributable to the fund's interest. We believe this approach is appropriate because it would reflect the amount borne by the fund and, by extension, the investors. This would be meaningful information for investors because the amount attributable to the fund's interest typically reduces the value of investors' indirect interest in the portfolio investment.<sup>56</sup> Subject to the requirements of the proposed rule, advisers may, but are not required to, also list the portion of the fee

attributable to any other investor's interest in the portfolio investment.

Similar to the approach discussed above with respect to adviser compensation and fund expenses, an adviser would be required to list the amount of portfolio investment compensation allocated or paid with respect to each covered portfolio investment both *before and after* the application of any offsets, rebates, or waivers. This would require an adviser to present the aggregate dollar amount attributable to the fund's interest before and after any such reduction for the reporting period. Advisers would be required to disclose the amount of any portfolio investment compensation they initially charge and the amount they ultimately retain at the expense of the private fund and its investors. As with adviser compensation and fund expenses, we believe this approach would provide investors with sufficient detail to validate that portfolio investment compensation borne by the fund conforms to contractual agreements.

**Ownership Percentage.** The proposed rule would require the portfolio investment table to list the fund's ownership percentage of each covered portfolio investment that paid or allocated portfolio-investment compensation to the adviser or its related persons during the reporting period.<sup>57</sup> The adviser would be required to determine the fund's ownership percentage as of the end of the reporting period. We believe that this information would provide investors with helpful context of the amount of portfolio investment compensation paid or allocated to the adviser or its related persons relative to the fund's ownership. For example, portfolio investment compensation may be calculated based on the portfolio investment's total enterprise value or other similar metric. We believe that the fund's ownership percentage would help private fund investors understand and assess the magnitude of such compensation, as well as how it affects the value of the fund's investment.

We recognize that calculating the fund's ownership percentage may be difficult in certain circumstances, especially for funds that do not make equity investments in operating companies. For example, a private equity secondaries fund may own a preferred security or a hybrid instrument that entitles the fund to

<sup>55</sup> See proposed rule 211(h)(1)–1 (defining “portfolio investment compensation”).

<sup>56</sup> We believe that this information would be meaningful for investors regardless of whether the private fund has an equity ownership interest or another kind of interest in the covered portfolio investment. For example, if a private fund's interest in a covered portfolio investment is represented by a debt instrument, the amount of portfolio-investment compensation paid or allocated to the adviser may hinder or prevent the covered portfolio investment from satisfying its obligations to the fund under the debt instrument.

<sup>54</sup> Because advisers often use separate legal entities to conduct a single advisory business, the proposed rule would capture portfolio investment compensation paid to an adviser's related persons.

<sup>57</sup> Proposed rule 211(h)(1)–2(c)(2). An adviser should also list zero percent as the ownership percentage if the fund has sold or completely written off its ownership interest in the covered portfolio investment during the reporting period.

priority distributions until it receives a certain return on its initial investment. A direct lending fund may provide a loan to a company that entitles the fund to receive interest payments and a return of principal. If the fund does not have an ownership interest in the covered portfolio investment, such as when the fund holds a debt instrument, the adviser would be required to list zero percent as the fund's ownership percentage, along with a brief description of the fund's investment in the portfolio investment table, if the covered portfolio investment paid or allocated portfolio-investment compensation to adviser or its related persons during the reporting period.

We request comment on all aspects of the proposed content of the portfolio investment table, including the following items:

- Would the proposed rule provide portfolio investment compensation disclosure that is meaningful to investors? Should the rule require advisers to disclose additional or different information in the portfolio-investment table? Would more information about the fees and expenses charged to portfolio investments be helpful for investors?

- Should we include any additional definitions of terms or phrases for the portfolio-investment table? Should we omit any definitions we have proposed for the portfolio-investment table?

- Is the proposed definition of "portfolio investment" clear? Should we modify or revise the proposed definition? For example, should we define "portfolio investment" as any person whose securities are beneficially owned by the private fund or any person in which the private fund owns an equity or debt interest? Alternatively, should we define "portfolio investment" as any underlying company, business, platform, issuer, or other person in which the private fund has made, directly or indirectly, an investment? Should we permit advisers to determine, in good faith, which entity or entities constitute the portfolio investment for purposes of the quarterly statement rule? For example, a fund of funds may indirectly invest in hundreds of issuers or entities. Depending on the underlying structure, control relationship, and reporting, the fund of funds' adviser may have limited knowledge regarding such underlying entities or issuers. Should we exclude such entities or issuers from the definition of portfolio investment for such advisers? Is there a different standard or test we should use? Should we require such adviser to conduct a reasonable amount of diligence

consistent with past practice and/or industry standards? Why or why not?

- As discussed above, to the extent a private fund enters into a negotiated instrument, such as a derivative, with a counterparty, we would not consider the private fund to have made an investment in the counterparty. Do commenters agree with this approach? Why or why not? Should we adopt a different approach for derivatives or other similar instruments generally? For purposes of determining whether the fund has made an investment in an issuer or entity, should we only include equity investments? Should we exclude derivatives? Why or why not? How should exchange-traded (*i.e.*, not negotiated) derivatives, including swaps and options, be treated for purposes of the rule?

- The proposed definition of portfolio investment would not distinguish among different types of private funds. Is our approach in this respect appropriate or should we treat certain funds differently depending on their strategy or fund type? If so, how should we reflect that treatment? For example, should we modify the definition with respect to a real estate fund to reflect that such a fund generally invests in real estate assets, rather than operating companies? Because a secondaries fund may indirectly invest in a significant number of underlying operating companies or other assets, should we limit the "indirect" component of the definition for such funds (or any other funds that may have indirect exposure to a significant number of companies or assets)? Why or why not? Would additional definitions be appropriate or useful? Should the proposed rule define the term "entity" and/or "issuer"? If so, how? Should the proposed rule treat hedge funds, liquidity funds, and other open-end private funds differently than private equity funds and other closed-end private funds?

- Should we adopt the approach with respect to portfolio-investment compensation as proposed? Do commenters agree with the scope of the proposal? Why or why not?

- The proposed rule includes non-exhaustive lists of certain types of fees. Would this information assist advisers in complying with the rule? Should we add any additional types? If so, which ones and why?

- Should we require advisers to list each type of portfolio-investment compensation as a separate line item as proposed? Would this level of detail be helpful for investors with respect to portfolio-investment reporting? Given that many funds require a management fee offset of all portfolio-investment

compensation, is this level of detail necessary or useful to investors? Should we instead require advisers to provide aggregate information for each covered portfolio investment?

- Should the rule permit advisers to use project or deal names or other codes, and if so, what additional disclosures are necessary for an investor to understand the nature of the conflicts?

- We considered only requiring advisers to disclose the amount of portfolio investment compensation after the application of any offsets, rebates, or waivers, rather than before and after. We believe the proposed approach would be more helpful for investors because investors would have greater insight into the compensation advisers initially charge and the amount they ultimately retain at the expense of the private fund and its investors. Do commenters agree? Why or why not?

- Would information about a firm's services to portfolio investments be helpful for investors? Are there any elements of the proposed requirements that firms should or should not include? If so, which ones and why?

- We considered requiring advisers to disclose the total portfolio-investment compensation for the reporting period as an aggregate number, rather than providing the amount of compensation allocated or paid by each covered portfolio investment as proposed. However, we believe that investment-by-investment information would provide investors with greater transparency into advisers' fee and expense practices and thus be more helpful for investors. Do commenters agree? Should we require advisers to report a consolidated "top-line" number that covers all covered portfolio investments?

- Should we define the term "ownership interest"? If so, how should we define it? For purposes of the rule, should a private fund be deemed to hold an "ownership interest" in a covered portfolio investment only to the extent the fund has made an equity investment in the covered portfolio investment? Why or why not? What types of funds may not hold an "ownership interest" in a covered portfolio investment?

- The proposed rule would require advisers to list the fund's ownership percentage of each covered portfolio investment. Because the definition of "portfolio investment" could capture more than one entity, will advisers be able to calculate the fund's ownership percentage? Are there any changes to the proposed rule text that could mitigate this challenge? If a portfolio investment captures multiple entities,

should we require advisers to list the fund's overall ownership of such entities? If so, what criteria should advisers use to determine a fund's overall ownership?

- Should we require advisers to disclose how they allocate or apportion portfolio-investment compensation among multiple private funds invested in the same covered portfolio investment? If so, how should the portfolio investment table reflect this information?

- Certain advisers have discretion or substantial influence over whether to cause a fund's portfolio investment to compensate the adviser or its related persons. Should the requirement to disclose portfolio-investment compensation apply only to advisers that have such discretion or authority? Should such requirement apply if the adviser is entitled to appoint one or more directors to the portfolio investment's board of directors or similar governing body (if applicable)? Is there another standard we should require?

- We recognize that certain private funds, such as quantitative and algorithmic funds and other similar funds, may have thousands of holdings and/or transactions during a quarter and that those funds typically do not receive portfolio investment compensation. While the proposed rule would not require an adviser to include any portfolio investment that did not pay or allocate portfolio-investment compensation to the adviser or its related persons during the reporting period in its quarterly statement, these advisers would need to consider how to identify such portfolio investment's payments and allocations for purposes of complying with this disclosure requirement. Should the rule provide any full or partial exceptions for such funds? Should we require investment-level disclosure for quantitative, algorithmic, and other similar funds only where they own above a specified threshold percentage of the portfolio investment? For example, should such funds only be required to provide investment-level disclosure where they own 25% or more ownership of any class of voting shares? Alternatively, should we use a lower ownership threshold, such as 20%, 10%, or 5%? Should we adopt a similar approach for all private funds, rather than just quantitative, algorithmic, and other similar funds? If so, what threshold should we apply? For instance, should it be 5%? Or 10%? A higher percentage?

- Should we exclude certain types of private funds from these disclosures? If so, which funds and how should we

define them? For example, should we exclude private funds that only hold (or primarily hold) publicly traded securities, such as hedge funds?

- Should we require layered disclosure for the portfolio-investment table (*i.e.*, short summaries of certain information with references and links to other disclosures where interested investors can find more information)? Would this approach encourage investors to ask questions and seek more information about the adviser's practices? Are there modifications or alternatives we should impose to improve the utility of the information for private fund investors, such as requiring the quarterly statement to present information in a tabular format?

- Are there particular funds that may require longer quarterly statements than other funds? Please provide data regarding the number of funds that have covered portfolio investments and, with respect to those funds, the number of covered portfolio investments per private fund. Should the Commission take into account the fact that certain funds will have more covered portfolio investments than other funds? For example, should we require funds that have more than a specific number of covered portfolio investments, such as 50 or more covered portfolio investments, to provide only portfolio-investment level reporting for a subset of their covered portfolio investments, such as a specific number of their largest holdings during the reporting period (*e.g.*, their largest ten, fifteen, or twenty holdings)?

- The proposed rule would require advisers to list zero percent as the ownership percentage if the fund has completely sold or completely written off its ownership interest in the covered portfolio investment during the reporting period. Instead, should we require or permit advisers to exclude any such portfolio investments from the table? Why or why not?

- The proposed rule would require the adviser to disclose the amount of portfolio investment compensation attributable to the private fund's interest in the covered portfolio investment that is paid or allocated to the adviser and its related persons. Should we require disclosure of portfolio compensation paid to other persons (such as co-investors, joint venture partners, and other third parties) to the extent such compensation reduces the value of the private fund's interest in the portfolio investment?

c. Calculations and Cross References to Organizational and Offering Documents

The proposed quarterly statement rule would require each statement to include prominent disclosure regarding the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated.<sup>58</sup> This would generally have the effect of requiring advisers to describe, for example, the structure of, and the method used to determine, any performance-based compensation set forth in the statement (such as the distribution waterfall, if applicable) and the criteria on which each type of compensation is based (*e.g.*, whether compensation is fixed, based on performance over a certain period, or based on the value of the fund's assets). We believe that this disclosure would assist private fund investors in understanding and evaluating the adviser's calculations.

To facilitate an investor's ability to seek additional information, the quarterly statement also must include cross references to the relevant sections of the private fund's organizational and offering documents that set forth the calculation methodology.<sup>59</sup> References to these disclosures would be valuable so that the investor can compare what the private fund's documents state the fund (and indirectly the investors) will be *obligated* to pay to what the fund (and indirectly the investors) *actually* paid during the reporting period and more easily determine the accuracy of the charges. For example, including this information on the quarterly statement would likely enable an investor to confirm that the adviser calculated advisory fees in accordance with the fund's organizational and offering documents and to identify whether the adviser deducted or charged incorrect or unauthorized amounts. We believe this information also would allow the investor to assess the effect those fees and costs have had on its investment.

We request comment on the following aspects of the proposed rule:

- Should we allow flexibility in the words advisers use, as proposed, or should we require advisers to include prescribed wording in disclosing calculation methodology? If the latter, what prescribed wording would be helpful for investors? Does the narrative style work or are there other presentation formats that we should require?

- Should we provide additional guidance or specify additional requirements regarding what type of

<sup>58</sup> Proposed rule 211(h)(1)–2(d).

<sup>59</sup> *Id.*

disclosure generally should or must be included to describe the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated? For example, should we provide sample disclosures describing various calculations? Should the rule require advisers to restate disclosures from offering memoranda (if applicable) regarding the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated in the quarterly statement? Do commenters believe that advisers would prefer to restate offering memoranda disclosures rather than drafting new disclosures to avoid conflicting interpretations of potentially complex fund terms? Should the rule only require advisers to provide a cross reference to the language in the fund's governing documents regarding this information (e.g., identifying the relevant document and page or section numbers)?

- Would providing cross references, as proposed, to the relevant sections of the private fund's organizational and offering documents be helpful for investors? Would it permit investors to "cross check" or evaluate the adviser's calculations? Are there other alternatives that would achieve our objectives?

## 2. Performance Disclosure

In addition to providing information regarding fees and expenses, the proposed rule would require an adviser to include standardized fund performance information in each quarterly statement provided to fund investors. The proposed rule would require an adviser to a liquid fund (as defined below) to show performance based on net total return on an annual basis since the fund's inception, over prescribed time periods, and on a quarterly basis for the current year. For illiquid funds (also defined below), the proposed rule would require an adviser to show performance based on the internal rate of return and a multiple of invested capital. The proposed rule would require an adviser to display the different categories of required performance information with equal prominence.<sup>60</sup>

<sup>60</sup> Proposed rule 211(h)(1)–2(e)(2). For example, the proposed rule would require an adviser to an illiquid fund to show gross internal rate of return with the same prominence as net internal rate of return. Similarly, the proposed rule would require an adviser to a liquid fund to show the annual net total return for each calendar year with the same prominence as the cumulative net total return for the current calendar year as of the end of the most recent calendar quarter covered by the quarterly statement.

It is essential that quarterly statements include performance in order to enable investors to compare private fund investments and comprehensively understand their existing investments and determine what to do holistically with their overall investment portfolio. A quarterly statement that includes fee, expense, and performance information would allow investors to monitor for abnormalities and better understand the impact of fees and expenses on their investments. For example, a quarterly statement that includes fee and expense, but not performance, information would not allow an investor to perform a cost-benefit analysis to determine whether to retain the current investment or consider other options or, for an investor in an illiquid fund, to determine whether to invest in other private funds managed by the same adviser. In addition, current clients or investors may use fee, expense, and performance information about their current investments to inform their overall investment decisions (e.g., whether to diversify) and their view of the market.

Although there are commonalities between the performance reporting elements of the proposed rule and the performance elements of our recently adopted marketing rule, the two rules satisfy somewhat different policy goals. Our experience has led us to believe that, while all clients and investors should be protected against misleading, deceptive, and confusing information, as is the policy goal of the marketing rule,<sup>61</sup> the needs of *current* clients and investors often differ in some respects from the needs of *prospective* clients and investors, as detailed below. Current investors should receive performance reporting that allows them to evaluate an investment alongside corresponding fee and expense information. Current investors also should receive performance reporting that is provided at timely, predictable intervals so that an investor can monitor and evaluate its investment progress over time, remain abreast of changes, compare information from quarter to quarter, and take action where possible.<sup>62</sup>

<sup>61</sup> See *Investment Adviser Marketing*, Investment Advisers Act Release No. 5653 (Dec. 22, 2021) ("Marketing Release"), at section II.A.2.a.iv (noting that the definition of "advertisement" includes a communication to a current investor that offers new or additional advisory services with regard to securities, provided that the communication otherwise satisfies the definition of "advertisement.").

<sup>62</sup> The marketing rule and its specific protections would generally not apply in the context of a quarterly statement. See Marketing Release, *supra* footnote 61, at sections II.A.2.a.iv and II.A.4. The

Currently, there are various approaches to report private fund performance to fund investors, often depending on the type of private fund (e.g., the fund's strategy, structure, target asset class, investment horizon, or liquidity profile). Certain of these approaches may be misleading without the benefit of well-disclosed assumptions, and others may lead to investor confusion. For example, an adviser showing internal rate of return with the impact of fund-level subscription facilities could mislead investors because that method of calculation would artificially increase performance metrics.<sup>63</sup> An adviser showing private fund performance as compared to a public market equivalent ("PME") in a case where the private fund does not have an appropriate benchmark could mislead investors to believe that the private fund performance will meet or exceed the performance of the PME. Certain investors may also mistakenly believe that their private fund investment has a liquidity profile that is similar to an investment in the PME or an index that is similar to the PME.

Without standardized performance metrics (and adequate disclosure of the criteria used and assumptions made in calculating the performance),<sup>64</sup> investors cannot compare their various private fund investments managed by the same adviser nor can they gauge the value of an adviser's investment management services by comparing the performance of private funds advised by different advisers.<sup>65</sup> Standardized performance information would help an investor decide whether to continue to invest in the private fund, if redemption is possible, as well as more holistically to make decisions about other components of the investor's portfolio. Furthermore, we believe that proposing to require advisers to show performance information alongside fee and expense information as part of the quarterly statement would paint a more complete picture of an investor's private fund investment. This would particularly provide context for investors that are

compliance date for the Marketing Rule is November 4, 2022.

<sup>63</sup> See *infra* section II.A.2.b. (Performance Disclosure: Illiquid Funds).

<sup>64</sup> Private funds can have various types of complicated structures and involve complex financing mechanisms. As a result, an adviser may need to make certain assumptions when calculating performance for private funds, specifically illiquid funds.

<sup>65</sup> See David Snow, *Private Equity: A Brief Overview: An introduction to the fundamentals of an expanding, global industry*, PEI Media (2007), at 11 (discussing variations on private equity performance metrics).



paying performance-based compensation and would help investors understand the true cost of investing in the private fund. This proposed performance reporting would also provide greater transparency into how private fund performance is calculated, improving an investor's ability to interpret performance results.<sup>66</sup>

The proposed rule recognizes the need for different performance metrics for private funds based on certain fund characteristics, but also imposes a general framework to ensure there is sufficient standardization in order to provide useful, comparable information to investors. An adviser would remain free to include other performance metrics in the quarterly statement as long as the quarterly statement presents the performance metrics prescribed by the proposed rule and complies with the other requirements in the proposed rule. However, advisers that choose to include additional information should consider what other rules and regulations might apply. For example, although we would not consider information in the quarterly statement required by the proposed rule to be an "advertisement" under the marketing rule, an adviser that offers new or additional investment advisory services with regard to securities in the quarterly statement would need to consider whether such information would be subject to the marketing rule.<sup>67</sup> An adviser would also need to consider whether performance information presented outside of the required quarterly statement, even if it contains some of the same information as the quarterly statement, would be subject to, and meet the requirements of, the marketing rule. Regardless, the quarterly statement would be subject to the anti-fraud provisions of the Federal securities laws.<sup>68</sup>

<sup>66</sup> Private fund investors increasingly request additional disclosure regarding private fund performance, including transparency into the calculation of the performance metrics. See, e.g., GPs feel the strain as LPs push for more transparency on portfolio performance and fee structures, Intertrust Group (July 6, 2020), available at <https://www.intertrustgroup.com/news/gps-feel-the-strain-as-lps-push-for-more-transparency-on-portfolio-performance-and-fee-structures/>; ILPA Principals 3.0, at 36 "Financial and Performance Reporting" and "Fund Marketing Materials," available at <https://ilpa.org/wp-content/flash/ILPA%20Principles%203.0/?page=36>.

<sup>67</sup> See 17 CFR 275.206(4)-1 (rule 206(4)-1). A communication to a current investor is an "advertisement" when it offers new or additional investment advisory services with regard to securities.

<sup>68</sup> This would include the anti-fraud provisions of section 206 of the Advisers Act, rule 206(4)-8 under the Advisers Act, section 17(a) of the Securities Act, and section 10(b) of the Exchange Act (and 17 CFR

#### Liquid v. Illiquid Fund Determination

The proposed performance disclosure requirements of the quarterly statement rule would require an adviser first to determine whether its private fund client is an illiquid or liquid fund, as defined in the proposed rule, no later than the time the adviser sends the initial quarterly statement.<sup>69</sup> The adviser would then be required to present certain performance information depending on this categorization. The purpose of these definitions is to distinguish which of the two particular performance reporting methods would apply and is most appropriate, resulting in a more accurate portrayal of the fund's returns over time and allowing for more standardized comparisons of the performance of similar funds.

We propose to define an illiquid fund as a private fund that: (i) Has a limited life; (ii) does not continuously raise capital; (iii) is not required to redeem interests upon an investor's request; (iv) has as a predominant operating strategy the return of the proceeds from disposition of investments to investors; (v) has limited opportunities, if any, for investors to withdraw before termination of the fund; and (vi) does not routinely acquire (directly or indirectly) as part of its investment strategy market-traded securities and derivative instruments.<sup>70</sup> We believe these factors are consistent with the characteristics of illiquid funds and these factors would align with the current factors for determining how certain types of private funds should report performance under U.S. Generally Accepted Accounting Principles ("U.S. GAAP").<sup>71</sup>

Private funds that fall into the proposed "illiquid fund" definition are generally closed-end funds that do not offer periodic redemption options, other than in exceptional circumstances, such as in response to regulatory events. They also do not invest in publicly traded securities, except for investing a *de minimis* amount of liquid assets. We believe that many private equity, real estate, and venture capital funds would fall into the illiquid fund definition, and therefore, the proposed rule would require advisers to these types of funds

240.10b-5 (rule 10b-5 thereunder)), to the extent relevant.

<sup>69</sup> Proposed rule 211(h)(1)-2(e)(1). The proposed rule does not require the adviser to revisit the determination periodically; however, advisers should generally consider whether they are providing accurate information to investors and whether they need to revisit the liquid/illiquid determination based on changes in the fund.

<sup>70</sup> Proposed rule 211(h)(1)-1 (defining "illiquid fund").

<sup>71</sup> See GAAP ASC 946-205-50-23/24.

to provide performance metrics that recognize their unique characteristics, such as irregular cash flows, which otherwise make measuring performance difficult for both advisers and investors as discussed below.

We propose to define a "liquid fund" as any private fund that is not an illiquid fund.<sup>72</sup> Private funds that fall into the "liquid fund" definition generally allow periodic investor redemptions, such as monthly, quarterly, or semi-annually. They also primarily invest in market-traded securities, except for a *de minimis* amount of illiquid assets, and therefore determine their net asset value on a regular basis. Most hedge funds would likely fall into the liquid fund definition, and therefore, the proposed rule would require advisers to these types of funds to provide performance metrics that show the year-over-year return using the market value of the underlying assets. We acknowledge, however, that there could be circumstances where an adviser would determine a hedge fund is an illiquid fund because it holds less liquid investments or has limited investors' ability to redeem some or all of their interests in the fund. We also recognize that some private funds may not neatly fit into the liquid or illiquid designations. For example, a hybrid fund is a type of private fund that can have characteristics of both liquid and illiquid funds, and whether the fund is treated as a liquid or illiquid fund under the rule would depend on the facts and circumstances.

In any case, the proposed rule would require advisers to provide performance reporting for each private fund as part of the fund's quarterly statement. The determination of whether a fund is liquid or illiquid dictates the type of performance reporting that must be included and, because it would result in funds with similar characteristics presenting the same type of performance metrics, we believe this approach would improve comparability of private fund performance reporting for fund investors. As indicated below, we welcome comment on whether these definitions lead to meaningful performance reporting for different types of private funds in light of the myriad fund strategies and structures.

We request comment on the following aspects of the proposed performance disclosure requirement:

- Should the proposed rule require advisers to include performance

<sup>72</sup> Proposed rule 211(h)(1)-1 (defining "liquid fund").

information in investor quarterly statements? Why or why not?

- Should the proposed rule require advisers to determine whether a private fund is a liquid or illiquid fund and provide performance metrics based on that determination? Alternatively, should the rule eliminate the definitions and give advisers discretion to provide the proposed performance metrics that they believe most accurately portray the fund's returns?

- Should we define "illiquid fund" and "liquid fund" as proposed or are there alternative definitions we should use? Are there other terms we should use for these purposes? For example, should we refer to the types of funds that would provide annual net total returns under the rule as "annual return funds" and those that would provide internal rates of return (IRR) and a multiple of invested cash (MOIC) under the rule as "IRR/MOIC funds"?

- Are the six factors used in the definition of "illiquid fund" sufficient to capture most funds for which an annual net total return is not an appropriate measure of performance? Are there any factors we should add? For example, should we add a factor regarding whether the fund produces irregular cash flows or whether the fund takes into account unrealized gains when calculating performance-based compensation? Should we add as a factor whether the private fund pays carried interest? Are there factors we should eliminate?

- Should we define additional terms or phrases used within the definition of "illiquid fund," such as "has as a predominant operating strategy the return of the proceeds from disposition of investments to investors"? Would this characteristic carve out certain funds, such as real estate funds and credit funds, for which we generally believe internal rates of return and a multiple of invested capital are the appropriate performance measures? If so, why? Should we eliminate or modify this characteristic in the definition of "illiquid fund"?

- Should the proposed rule define a "liquid fund" based on certain characteristics? If so, what characteristics? For example, should we define it as a private fund that requires investors to contribute all, or substantially all, of their capital at the time of investment, and invests no more than a *de minimis* amount of assets in illiquid investments? If so, how should we define "illiquid investments"? Are there other characteristics relating to redemptions, cash flows, or tax treatment that we should use to define

the types of funds that should provide annual net total return metrics?

- Will advisers be able to determine whether a private fund it manages is a liquid or illiquid fund? For example, how would an adviser classify certain types of hybrid funds under the proposed rule? Should the rule include a third category of funds for hybrid or other funds? If so, what definition should we use? Should we amend the proposed definitions if we adopt a third category of funds (e.g., should we revise the definition of "liquid fund" given that the proposal defines "liquid fund" as any private fund that is not an illiquid fund)? If a fund falls within the third category, should the rule require or permit the private fund to provide performance metrics that most accurately portray the fund's returns?

- Are there scenarios in which an adviser might initially classify a fund as illiquid, but the fund later transitions to a liquid fund (or vice versa)? Should we provide additional flexibility in these circumstances? Should the proposed rule require advisers to revisit periodically their determination of a fund's liquidity status? For example, should the proposed rule require advisers to revisit the liquid/illiquid determination annually, semi-annually, or quarterly?

- How would an adviser to a private fund with an illiquid side pocket classify the private fund under the proposed rule's definitions for liquid and illiquid funds? For example, would the adviser treat the entire private fund as illiquid because of the side pocket? Why or why not? Should we permit or require the adviser to classify the side pocket as an illiquid fund, with the remaining portion of the private fund classified as a liquid fund?

- Instead of requiring advisers to show performance with equal prominence, should the proposed rule instead allow advisers to feature certain performance with greater prominence than other performance as long as all of the information is included in the quarterly statement? Why or why not?

#### a. Liquid Funds

The proposed rule would require advisers to liquid funds to disclose performance information in quarterly statements for the following periods. First, an adviser to a liquid fund would be required to disclose the liquid fund's annual net total returns for each calendar year since inception. For example, a liquid fund that commenced operations four calendar years ago would show annual net total returns for each of the first four years since its

inception.<sup>73</sup> We believe this information would provide fund investors with a comprehensive overview of the fund's performance over the life of the fund and improve an investor's ability to compare the fund's performance with other similar funds. As noted above, investors can use performance information in connection with fee and expense information to analyze the value of their private fund investments. The proposed requirement would prevent advisers from including only recent performance results or presenting only results or periods with strong performance. For similar reasons, it also would require an adviser to present these various time periods with equal prominence.

Second, the adviser would be required to show the liquid fund's average annual net total returns over the one-, five-, and ten-calendar year periods.<sup>74</sup> However, if the private fund did not exist for one of these prescribed time periods, then the adviser would not be required to provide that information. Requiring performance over these time periods would provide investors with standardized performance metrics that would reflect how the private fund performed during different market or economic conditions. These time periods would provide reference points for private fund investors, particularly when comparing two or more private fund investments, and would provide private fund investors with aggregate performance information that can serve as a helpful summary of the fund's performance.

Third, the adviser would be required to show the liquid fund's cumulative net total return for the current calendar year as of the end of the most recent calendar quarter covered by the quarterly statement. For example, a liquid fund that has been in operations for four calendar years (beginning on January 1) and seven months would show the cumulative net total return for the current calendar year through the end of the second quarter. We believe this information would provide fund investors with insight into the fund's most recent performance, which investors could use to assess the fund's performance during current market

<sup>73</sup> If a private fund's inception date were other than on the first day of a calendar year, the private fund would show performance for a stub period and then show calendar year performance. For example, if the four-year period ended on October 31, 2021, and the fund's inception date was August 31, 2017, the fund would show full calendar year performance for 2018, 2019, and 2020, and partial year performance in 2017.

<sup>74</sup> Proposed rule 211(h)(1)–2(e)(2)(i)(B).

conditions. This quarterly performance information also would provide helpful context for reviewing and monitoring the fees and expenses borne by the fund during the quarter, which the quarterly statement would disclose.

We believe these performance metrics would allow investors to assess these funds' performance because they ordinarily invest in market-traded securities, which are primarily liquid. As a result, liquid funds generally are able to determine their net asset value on a regular basis and compute the year-over-year return using the market-based value of the underlying assets. We have taken a similar approach with regard to registered funds, which also invest a substantial amount of their assets in primarily liquid underlying holdings (e.g., publicly traded securities).<sup>75</sup> As a result, liquid funds, like registered funds, currently generally report performance on an annual and quarterly basis. Investors in a private fund that is a liquid fund would similarly find this information helpful. Most traditional hedge funds would likely fall into the liquid bucket and would need to provide disclosures regarding the underlying assumptions of the performance (e.g., whether dividends or other distributions are reinvested).<sup>76</sup>

We request comment on the following with respect to the proposed liquid fund performance requirement:

- Should we require advisers to provide annual net total returns for liquid funds, as proposed? Would showing annual net total returns for each calendar year since a private fund's inception be overly burdensome for older funds? Would performance information that is more than 10 years old be useful to investors? Why or why not?

- Should the proposed rule define "annual net total return" or specify the format in which advisers must present the annual net total returns? Should the proposed rule specify how advisers should calculate the annual net total return, similar to Form N-1A?<sup>77</sup>

- The proposed rule would require advisers to provide performance information for each calendar year since inception and over prescribed time periods (one-, five-, and ten-year periods). Should the proposed rule instead only require an adviser to satisfy

one of these requirements (i.e., provide performance each calendar year since inception or provide performance over the prescribed time periods)? For funds that have not been in existence for one of the prescribed time periods, should the proposed rule require the adviser to show the average annual net total return since inception, instead of the prescribed time period?

- The proposed rule would require advisers to provide average annual net total returns for the private fund over the one-, five-, and ten-calendar year periods. However, the proposal would not prohibit advisers from providing additional information. Should we allow advisers to provide performance information for annual periods other than calendar years?

- Should the proposed rule define "average annual net total return" or specify the format in which advisers must present the average annual net total returns?

- The proposed rule would require an adviser to provide "the cumulative net total return for the current calendar year." Instead of using the word "cumulative" net total return, should the rule use the phrase "year to date" net total return?

- To the extent certain liquid funds quote yields rather than returns, should such funds be required or permitted to quote yields in addition to or instead of returns?

#### b. Illiquid Funds

The proposed rule would require advisers to illiquid funds to disclose the following performance measures in the quarterly statement, shown since inception of the illiquid fund and computed without the impact of any fund-level subscription facilities:

- (i) Gross internal rate of return and gross multiple of invested capital for the illiquid fund;

- (ii) Net internal rate of return and net multiple of invested capital for the illiquid fund; and

- (iii) Gross internal rate of return and gross multiple of invested capital for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately.

The proposed rule also would require advisers to provide investors with a statement of contributions and distributions for the illiquid fund.<sup>78</sup>

*Since Inception.* The proposed rule would require an adviser to disclose the illiquid fund's performance measures since inception. This proposed requirement would prevent advisers

from including only recent performance results or presenting only results or periods with strong performance, which could mislead investors. We propose to require this for all illiquid fund performance measures under the proposed rule, including the measures for the realized and unrealized portions of the illiquid fund's portfolio.

The proposed rule would require an adviser to include performance measures for the illiquid fund through the end of the quarter covered by the quarterly statement. We recognize, however, that certain funds may need information from portfolio investments and other third parties to generate performance data and thus may not have the necessary information prior to the distribution of the quarterly statement. Accordingly, to the extent quarter-end numbers are not available at the time of distribution of the quarterly statement, an adviser would be required to include performance measures through the most recent practicable date, which we generally believe would be through the end of the quarter immediately preceding the quarter covered by the quarterly statement. The proposed rule would require the quarterly statement to reference the date the performance information is current through (e.g., December 31, 2021).<sup>79</sup>

*Computed Without the Impact of Fund-Level Subscription Facilities.* The proposed rule would require advisers to calculate performance measures for each illiquid fund as if the private fund called investor capital, rather than drawing down on fund-level subscription facilities.<sup>80</sup> Such facilities enable the fund to use loan proceeds—rather than investor capital—to initially fund investments and pay expenses. This practice permits the fund to delay the calling of capital from investors, which has the potential to increase performance metrics artificially.

Many advisers currently provide performance figures that reflect the impact of fund-level subscription facilities. These "levered" performance figures often do not reflect the fund's actual performance and have the potential to mislead investors.<sup>81</sup> For

<sup>79</sup> Proposed rule 211(h)(1)–2(e)(2)(iii).

<sup>80</sup> As discussed below, the proposed rule would also require advisers to prominently disclose the criteria used, and assumptions made, in calculating performance. This would include the criteria and assumptions used to prepare an illiquid fund's unlevered performance measures.

<sup>81</sup> We recognize that fund-level subscription facilities can be an important cash management tool for both advisers and investors. For example, a fund may use a subscription facility to reduce the overall number of capital calls and to enhance its ability to execute deals quickly and efficiently.

<sup>75</sup> See Form N-1A. This form requires registered investment companies to report to investors and file with the SEC documents containing the fund's annual total returns by calendar year and the highest and lowest returns for a calendar quarter, among other performance information.

<sup>76</sup> See *infra* section II.A.2.c (Prominent Disclosure of Performance Calculation Information).

<sup>77</sup> See Form N-1A, Item 26(b).

<sup>78</sup> Proposed rule 211(h)(1)–2(e)(2)(ii).

example, an investor could reasonably believe that levered performance results are similar to those that the investor has achieved from its investment in the fund. We believe that unlevered performance figures would provide investors with more meaningful data and improve the comparability of returns.

We propose to define “fund-level subscription facilities” as any subscription facilities, subscription line financing, capital call facilities, capital commitment facilities, bridge lines, or other indebtedness incurred by the private fund that is secured by the unfunded capital commitments of the private fund’s investors.<sup>82</sup> This definition is designed to capture the various types of subscription facilities prevalent in the market that serve as temporary replacements or substitutes for investor capital.<sup>83</sup>

We would generally interpret the phrase computed without the impact of fund-level subscription facilities to require advisers to exclude fees and expenses associated with the subscription facility, such as the interest expense, when calculating net performance figures and preparing the statement of contributions and distributions. This approach would cause the net returns for many funds to be higher than would be the case if such amounts were included. We believe that this approach is appropriate, however, because it is consistent with the policy goal of this aspect of the proposed rule (*i.e.*, requiring advisers to show private fund investors the returns the fund would have achieved if there were no subscription facility).<sup>84</sup> We request comment below on whether this approach is appropriate.

**Fund-Level Performance.** The proposed rule would require an adviser to disclose an illiquid fund’s gross and

net internal rate of return and gross and net multiple of invested capital for the illiquid fund. The proposed rule also would require an adviser to provide a statement of contributions and distributions for the illiquid fund reflecting the aggregate cash inflows from investors and the aggregate cash outflows from the fund to investors, along with the fund’s net asset value.

We recognize that illiquid funds have unique characteristics, such as irregular cash flows, that make measuring performance difficult for both advisers and investors. We also recognize that internal rate of return and multiple of invested capital, each as discussed below, have their drawbacks as performance metrics.<sup>85</sup> We believe, however, that these metrics, combined with a statement of contributions and distributions reflecting cash flows, would help investors holistically understand the fund’s performance, allow investors to diligence the fund’s performance, and calculate other performance metrics they may find helpful. When presented in accordance with the conditions and other disclosures required under the proposed rule, such standardized reporting measures would provide meaningful performance information for investors, allowing them to compare returns among funds and also to make more-informed decisions.

We propose to define “internal rate of return” as the discount rate that causes the net present value of all cash flows throughout the life of the private fund to be equal to zero.<sup>86</sup> Cash flows would be represented by capital contributions (*i.e.*, cash inflows) and fund distributions (*i.e.*, cash outflows), and the unrealized value of the fund would be represented by a fund distribution (*i.e.*, a cash outflow). This definition would provide investors with a time-adjusted return that takes into account the size and timing of a fund’s cash flows and its unrealized value at the time of calculation.<sup>87</sup>

<sup>85</sup> For example, multiple of invested capital does not factor in the amount of the time it takes for a fund to generate a return, and internal rate of return assumes early distributions will be reinvested at the same rate of return generated at the initial exit.

<sup>86</sup> Proposed rule 211(h)(1)–1 (defining “gross IRR” and “net IRR”).

<sup>87</sup> When calculating a fund’s internal rate of return, an adviser would need to take into account the specific date a cash flow occurred (or is deemed to occur). Certain electronic spreadsheet programs have “XIRR” or other similar formulas that require the user to input the applicable dates. The proposed requirement that an illiquid fund present its performance using an internal rate of return aligns with the U.S. GAAP criteria used to determine when a private fund must present performance using an internal rate of return in its audited

We propose to define “multiple of invested capital” as (i) the sum of: (A) The unrealized value of the illiquid fund; and (B) the value of all distributions made by the illiquid fund; (ii) divided by the total capital contributed to the illiquid fund by its investors.<sup>88</sup> This definition is intended to provide investors with a measure of the fund’s aggregate value (*i.e.*, the sum of clauses (i)(A) and (i)(B)) relative to the capital invested (*i.e.*, clause (ii)) as of the end of the applicable reporting period. Unlike the definition of internal rate of return, the multiple of invested capital definition would not take into account the amount of time it takes for a fund to generate a return (meaning that the multiple of invested capital measure would focus on “how much” rather than “when”).

We believe that the proposed definitions of internal rate of return and multiple of invested capital are generally consistent with how the industry currently calculates such performance metrics. For example, most advisers use electronic spreadsheet programs to calculate a fund’s internal rate of return. Such programs typically calculate the internal rate of return as the interest rate for an investment consisting of payments (cash outflows) and income (cash inflows) received over a period.<sup>89</sup> However, we have observed certain advisers deviate from standard formulas, or make various assumptions, when calculating a private fund’s performance. Accordingly, we believe that prescribing definitions would decrease the risk of different advisers presenting internal rate of return and multiple of invested capital performance figures that are not comparable. Both definitions are designed to limit any deviations in calculating the standardized performance prescribed by the proposed rule. We believe that this approach is appropriate because it would provide a degree of standardization and provide investors with the relevant information to compare performance.

An adviser would be required to present each performance metric on a gross and net basis.<sup>90</sup> Under the proposed rule, an illiquid fund’s gross

financial statements. *See* U.S. GAAP ASC 946–205–50–23/24.

<sup>88</sup> Proposed rule 211(h)(1)–1 (defining “gross MOIC” and “net MOIC”).

<sup>89</sup> *See, e.g.*, IRR Function, available at <https://support.microsoft.com/en-us/office/irr-function-64925eaa-9988-495b-b290-3ad0c163c1bc> (noting that the internal rate of return is closely related to net present value and that the rate of return calculated by the internal rate of return is the interest rate corresponding to a zero net present value).

<sup>90</sup> Proposed rule 211(h)(1)–2(e)(2)(ii).

<sup>82</sup> Proposed rule 211(h)(1)–1. The proposed rule defines “unfunded capital commitments” as committed capital that has not yet been contributed to the private fund by investors, and “committed capital” as any commitment pursuant to which a person is obligated to acquire an interest in, or make capital contributions to, the private fund. *See id.*

<sup>83</sup> We recognize that a private fund may guarantee portfolio investment indebtedness. In such a situation, if the portfolio investment does not have sufficient cash flow to pay its debt obligations, the fund may be required to cover the shortfall to satisfy its guarantee. Even though investors’ unfunded commitments may indirectly support the fund’s guarantee, the proposed definition would not cover such fund guarantees. Unlike fund-level subscription facilities, such guarantees generally are not put in place to enable the fund to delay the calling of investor capital.

<sup>84</sup> The proposed rule nevertheless would require advisers to reflect the fees and expenses associated with the subscription facility in the quarterly statement’s fee and expense table.

performance would not reflect the deduction of fees, expenses, and performance-based compensation borne by the private fund.<sup>91</sup> We believe that presenting both gross and net performance measures for the illiquid fund would prevent investors from being misled. We believe that gross performance would provide insight into the profitability of underlying investments selected by the adviser. Solely presenting gross performance, however, may imply that investors have received the full amount of such returns. The net performance would assist investors in understanding the actual returns received and, when presented alongside gross performance, the negative effect fees, expenses, and performance-based compensation have had on past performance.

The proposed rule also would require an adviser to provide a statement of contributions and distributions for the illiquid fund. We believe this would provide private fund investors with important information regarding the fund's performance because it would reflect the underlying data used by the adviser to generate the fund's returns, which, in many cases, is not currently provided to private fund investors. Such data would allow investors to diligence the various performance measures presented in the quarterly statement. In addition, this data would allow the investors to calculate additional performance measures based on their own preferences.

We propose to define statement of contributions and distributions as a document that presents:

- (i) All capital inflows the private fund has received from investors and all capital outflows the private fund has distributed to investors since the private fund's inception, with the value and date of each inflow and outflow; and
- (ii) The net asset value of the private fund as of the end of the reporting period covered by the quarterly statement.<sup>92</sup>

For similar reasons to those discussed above, the proposed rule would require an adviser to prepare the statement of contributions and distributions without the impact of any fund-level subscription facilities. This would require an adviser to assume the private fund called investor capital, rather than drawing down on fund-level subscription facilities. To avoid double counting capital inflows, the amount borrowed under the subscription facility generally should be reflected as a capital

inflow from investors and an equal dollar amount of actual capital inflows from investors generally should not be reflected on the statement.

*Realized and Unrealized Performance.* The proposed rule also would require an adviser to disclose a gross internal rate of return and gross multiple of invested capital for the realized and unrealized portions of the illiquid fund's portfolio, with the realized and unrealized performance shown separately.

The value of the unrealized portion of an illiquid fund's portfolio typically is determined by the adviser and, given the lack of readily available market values, can be challenging. For example, an adviser's valuation policies and procedures for illiquid investments may rely on models and unobservable inputs. This creates a conflict of interest because the adviser is typically evaluated and, in certain cases, compensated based on the fund's unrealized performance. Further, investors often decide whether to invest in a successor fund based on the predecessor fund's performance. These factors create an incentive for the adviser to inflate the value of the unrealized portion of the illiquid fund's portfolio. We believe highlighting the performance of the fund's unrealized investments would assist investors in determining whether the aggregate, fund-level performance measures present an overly optimistic view of the fund's overall performance. For example, if the performance of the unrealized portion of the fund's portfolio is significantly higher than the performance of the realized portion, it may imply that the adviser's valuations are overly optimistic or otherwise do not reflect the values that can be realized in a transaction or sale with an independent third party.

The proposed rule would only require an adviser to disclose gross performance measures for the realized and unrealized portions of the illiquid fund's portfolio. We believe that calculating net figures could involve complex and potentially subjective assumptions regarding the allocation of fund-level fees, expenses, and adviser compensation between the realized and unrealized portions of the portfolio.<sup>93</sup> In our view, such assumptions would likely diminish the benefits net performance measures would provide.

We request comment on the following with respect to the proposed illiquid fund performance requirement:

- Are the proposed performance metrics appropriate? Why or why not? We recognize that advisers often utilize different performance metrics for different funds. Should we add any other metrics to the proposed rule? For example, should we require a public market equivalent or variations of internal rate of return, such as a modified internal rate of return that assumes cash flows are reinvested at modest rates of return or otherwise incorporates a cost of capital concept for funds that do not draw down all, or substantially all, of investor capital at the time of investment? If so, should we prescribe a benchmark for the cost of capital and reinvestment rates?
- The proposed rule would not distinguish among different types of illiquid funds. Is our approach in this respect appropriate or should we treat certain illiquid funds differently? If so, how should we reflect that treatment?
- Are there additional guardrails we should add to the proposed rule to achieve the policy goal of providing investors with comparable performance information? If so, please explain. Are there practices that advisers use or assumptions that advisers make, when calculating performance that we should require, curtail, or otherwise require advisers to disclose?
- Although some investors receive certain annual performance information about a private fund if that fund is audited and distributes financial statements prepared in accordance with U.S. GAAP, we believe that the proposed rule's performance information would be helpful for private fund investors because it would require performance information to be reported at more frequent intervals in a standardized manner. Do commenters agree? To the extent there are differences (e.g., the requirement that performance be computed without the impact of any fund-level subscription facilities), would investors find this confusing? Would disclosure regarding these differences help to alleviate investor confusion?
- Would investor confusion or other concerns arise from requiring performance information in the quarterly statement as proposed?
- What, if any, burdens would be associated with this aspect of the proposed rule? How can we minimize any associated burdens while still achieving our goals?
- Are the proposed definitions appropriate and clear? If not, how should we clarify the definitions?

<sup>91</sup> See proposed rule 211(h)(1)-1 (defining "gross IRR," "net IRR," "gross MOIC," and "net MOIC").

<sup>92</sup> Proposed rule 211(h)(1)-1.

<sup>93</sup> For example, an adviser would have to determine how to allocate fund organizational expenses between the realized and unrealized portions of the portfolio.

Should we modify or eliminate any? Would additional definitions be appropriate or useful? For example, should we define any of the terms used in the definition of internal rate of return, such as “net present value” or “discount rate”? If so, what definitions should we use?

- Are the definitions of gross IRR, gross MOIC, net IRR, and net MOIC appropriate? Should we provide further guidance or specify requirements in the proposed rule on how to calculate gross performance or net performance? If so, what guidance or requirements? Should we require advisers to adopt policies and procedures prescribing specific methodologies for calculating gross performance and net performance? Why or why not? When calculating net performance, are there additional fees and expenses that advisers should include? Alternatively, should we expressly permit advisers to exclude certain fees and expenses when calculating net performance figures, such as taxes incurred to accommodate certain, but not all, investor preferences? Why or why not?

- Similarly, are the definitions of gross IRR and gross MOIC appropriate for purposes of calculating the performance metrics of the realized and unrealized portions of the illiquid fund’s portfolio? Should we modify such definitions to reference specifically the realized and unrealized portions of the portfolio, rather than only referencing the illiquid fund? For example, should the definition of MOIC be revised to mean, as of the end of the applicable calendar quarter: (i) The sum of (A) the unrealized value of applicable portion of the illiquid fund’s portfolio, and (b) the value of all distributions made by the illiquid fund attributable to the applicable portion of the illiquid fund’s portfolio; (ii) divided by the total capital contributed to the illiquid fund by its investors attributable to the applicable portion of the illiquid fund’s portfolio? Are there other variations we should impose? Why or why not?

- The Global Investment Performance Standards (“GIPS”) are a set of voluntary standards for calculating and presenting investment performance. For purposes of calculating an illiquid fund’s performance under the proposed rule, are there any elements found in the GIPS standards that we should require? For example, should we require advisers to disclose composite cumulative committed capital,<sup>94</sup> or should we

require advisers to disclose performance with and without the impact of subscription facilities? Are there any definitions we should revise or propose to be consistent with the definitions used in the GIPS standards? For example, the GIPS standards define “internal rate of return” as the return for a period that reflects the change in value and the timing and size of external cash flows and “multiple of invested capital” as the total value divided by since inception paid-in capital.<sup>95</sup> If we were to adopt such definitions, do commenters believe that such definitions would result in different performance numbers for illiquid funds, as compared to the performance numbers that advisers would disclose under the proposed definitions? Why or why not? Please provide examples.

- We recognize that advisers and their related persons typically invest in private funds on a “fee-free, carry-free” basis (*i.e.*, they are not required to pay management fees or performance-based compensation). When calculating a fund’s performance, how should such interests be taken into account? Should we require advisers to exclude such interests from the calculations, especially the net performance figures?

- The proposed rule would require advisers to calculate the various performance measures without the impact of any fund-level subscription facilities. Do commenters agree with this approach? Should the proposed rule require advisers to provide the same performance measures *with* the impact of fund-level subscription facilities? Why or why not? The proposed rule does not prohibit advisers from providing the same performance measures with the impact of fund-level subscription facilities. Should we prohibit advisers from doing so?

- Should we define the term “computed without the impact of any fund-level subscription facilities”? Should we provide additional guidance or requirements regarding how advisers generally should or must calculate such performance measures? If so, what guidance or requirements should we provide?

- We recognize that a fund-level subscription facility has the potential to

aggregation of one or more portfolios that are managed according to a similar investment mandate, objective, or strategy. The term cumulative is not defined in the GIPS standards. Global Investment Performance Standards (GIPS) For Firms: Glossary, CFA Institute (2020), available at <https://www.cfainstitute.org/-/media/documents/code/gips/2020-gips-standards-firms.pdf>.

<sup>95</sup> Internal rate of return is referred to as money-weighted return in the GIPS standards, and multiple of invested capital is referred to as investment multiple.

have a greater impact on a fund’s internal rate of return as compared to its multiple of invested capital. Should advisers only be required to provide “unlevered” internal rates of return and not “unlevered” multiples of invested capital? If the fund realizes an investment prior to calling any capital from investors in respect of such investment, how would an adviser calculate a multiple for such investment?

- The proposed rule would require advisers to prepare the statement of contributions and distributions without the impact of any fund-level subscription facilities. Would this information be helpful for investors? Would advisers be able to prepare such a statement without making arbitrary assumptions? Why or why not? For example, would advisers need to make assumptions in calculating the preferred return (if applicable)?

- The proposed rule would require only gross performance measures for the realized and unrealized portion of the illiquid fund’s portfolio. Should the proposed rule require net performance information as well? Would net performance measures be beneficial for investors despite the drawbacks discussed above? What assumptions should we require in calculating net information? What limitations, if any, would advisers face in providing net performance measures?

- Should we define the phrases “unrealized portion of the illiquid fund’s portfolio” and “realized portion of the illiquid fund’s portfolio”? For example, should we define the realized portion to include not only completely realized investments but also substantially realized investments to the extent the fund’s remaining interest is *de minimis*? Why or why not?

- Should we require advisers to disclose the dollar amounts of the realized and unrealized portions of the portfolio? Should we also require advisers to disclose such amounts as percentages? For example, if the value of the realized portion of the portfolio is \$250 million and the value of the unrealized portion is \$750 million, should we require advisers to disclose those amounts, both as dollar values and percentages (*i.e.*, 25% (\$250 million) of the illiquid fund’s portfolio is realized, and 75% (\$750 million) remains unrealized)?

- The proposed rule would require advisers to provide cumulative performance reporting since inception of the illiquid fund each quarter. Is this the right approach? Should the proposed rule require performance since inception for each quarter or on an

<sup>94</sup> The GIPS standards define “committed capital” as pledges of capital to an investment vehicle by investors (limited partners and the general partner) or the firm. The term “composite” is defined as an

annual basis? Should the proposed rule remove the “since inception” requirement for quarterly reports and instead require performance for each quarter of the current year, and cumulative performance for the current year? If so, why or why not?

- Should we prescribe specific periods for illiquid fund performance reporting? For example, should we prescribe one-, five-, and/or ten-year time periods? Instead, should we require that advisers always present performance since inception as proposed? Are there other periods for which we should require the presentation of performance results? Are there any specific compliance issues that an adviser would face in generating and presenting performance results for the required period? For example, would advisers have the requisite information to generate or support performance figures for older funds from the proposed recordkeeping requirements and/or performance presentation requirements? If not, should we provide an exemption for advisers that lack such information?

- Liquid funds often have longer terms than illiquid funds. To the extent an illiquid fund has been in existence for an extended period of time, such as more than ten years, should the rule prescribe specific periods for performance reporting for such funds (e.g., one-, five-, and/or ten-year time periods)?

- Should we require that advisers provide performance results current through the end of the quarter covered by the quarterly statement as proposed? In circumstances where quarter-end numbers are not available at the time of distribution of the quarterly statement, should we require an adviser to include performance measures through the most recent practicable date as proposed? Should we define, or provide additional guidance about, the term “most recent practicable date”? If so, what definition or additional guidance should we provide?

- Should the proposed rule require advisers to make certain, standard disclosures tailored to each of the performance metrics mandated in the proposed rule? For example, should we require advisers to illiquid funds that are required to display internal rate of return to disclose prominently that the returns do not represent returns on the investor’s capital commitment and instead only reflect returns on the investor’s contributed capital? Should we require advisers to disclose that an investor’s actual return on its capital commitment will depend on how the

investor invests its uncalled commitments?

- As noted above, we would generally interpret the phrase computed without the impact of fund-level subscription facilities to require advisers to exclude fees and expenses associated with the subscription facility, such as the interest expense, when calculating net performance figures and preparing the statement of contributions and distributions. Do commenters agree with this approach? Should we require advisers to include such amounts instead? Are there other assumptions advisers would need to make in calculating performance information that the rule should address?

- The proposed rule would require the statement of contributions and distributions to reflect the private fund’s net asset value as of the end of the applicable quarter. Should we require advisers to provide additional detail regarding the unrealized value of the private fund? For example, should we require advisers to reflect the portion of such net asset value that would be required to be paid to the adviser as performance-based compensation assuming a hypothetical liquidation of the fund?

- The statement of contributions and distributions generally reflects aggregate, fund-level numbers. Should we also require a statement of contributions and distributions for each underlying investment? Would a statement of each investment’s cash flows be useful to investors? Why or why not? Would such a requirement be too burdensome for certain advisers, especially advisers to private funds that have a significant number of investments? Should this requirement only apply to certain types of funds, such as private equity, venture capital, or other similar funds that may invest in operating companies?

- Should we provide further guidance or specify requirements on how advisers generally should or must present performance? For example, should we require advisers to present the various performance metrics with equal prominence as proposed? Should we require advisers to present performance information in a format designed to facilitate comparison? Should we provide additional guidance or requirements regarding how an adviser should or must calculate the proposed performance metrics? Is there additional information that we should require advisers to disclose when presenting performance?

- Should we provide further guidance or specify requirements in the rule on how advisers generally should or must

treat taxes for purposes of calculating performance? For example, should the rule state that advisers may exclude taxes paid or withheld with respect to a particular investor or by a blocker corporation (but not the illiquid fund as a whole)?

#### c. Prominent Disclosure of Performance Calculation Information

The proposed rule would require advisers to include prominent disclosure of the criteria used and assumptions made in calculating the performance. Information about the criteria used and assumptions made would enable the private fund investor to understand how the performance was calculated and help provide useful context for the presented performance metrics. Additionally, while the proposed rule includes detailed information about the type of performance an adviser must present for liquid and illiquid funds, it is still possible that advisers would make certain assumptions or rely on specific criteria that the proposed rule’s requirements do not address specifically.

For example, the proposed rule would require an adviser to display, for a liquid fund, the annual returns for each calendar year since the fund’s inception. If the adviser made any assumptions in performing that calculation, such as whether dividends were reinvested, the adviser should disclose those assumptions in the quarterly statement. As another example, for an illiquid fund, the proposed rule would require an adviser to display the net internal rate of return and net multiple of invested capital. In this case, the adviser should disclose the assumed fee rates, including whether the adviser is using fee rates set forth in the fund documents, whether it is using a blended rate or weighted average that would factor in any discounts, or whether it is using a different method for calculating net performance. The proposed rule requires the disclosure to be within the quarterly statement.<sup>96</sup> Thus, an adviser may not provide the information only in a separate document, website hyperlink or QR code, or other separate disclosure.<sup>97</sup> We believe that this information is integral to the quarterly statement because it would enable the investor to understand and analyze the performance information better and better compare the performance of funds and advisers

<sup>96</sup> Proposed rule 211(h)(1)–2(e)(2)(iii).

<sup>97</sup> See also Marketing Release, *supra* at footnote 61 (discussing clear and prominent disclosures in the context of advertisements).



without having to access other ancillary documents. As a result, investors should receive it as part of the quarterly statement itself.

We request comment on this aspect of the proposal:

- Should we require advisers to disclose the criteria used and assumptions made in calculating the performance as part of the quarterly statement as proposed? Is this approach too flexible? Should we instead prescribe required disclosures?

- Should we require advisers to provide these disclosures prominently as proposed? Is there another disclosure standard we should use for these purposes?

- Because we propose to require an adviser to provide these disclosures as part of each quarterly statement, investors would receive these disclosures quarterly. Would providing these disclosures every quarter reduce their salience? Should we require these disclosures only as part of the first quarterly statement that an adviser sends to an investor with amendments if the criteria used or assumptions made in calculating performance change? Should we permit hyperlinking to these disclosures after the initial quarterly statement?

### 3. Preparation and Distribution of Quarterly Statements

The proposed rule would require quarterly statements to be prepared and distributed to fund investors within 45 days after each calendar quarter end. We believe quarterly statements would provide fund investors with timely and regular statements that contain meaningful and comprehensive information. We understand that most private fund advisers currently provide investors with quarterly reporting.<sup>98</sup>

For a newly formed private fund, the proposed rule would require a quarterly statement to be prepared and distributed beginning after the fund's second full calendar quarter of generating operating results. Many private funds may not have performance information that is readily available within the first several months of operations. For example, a private equity fund might not begin investing until several months after the fund's formation because the adviser is still identifying investments that align with the fund's strategy. As another example, a hedge fund may hold initial investor capital in cash or cash equivalents, prior to commencing the

fund's investment strategy. Accordingly, we believe that the proposed requirements for newly formed funds would help ensure that investors receive comprehensive information about the adviser during the early stage of the fund's life. The reporting period for the final quarterly statement would cover the calendar quarter in which the fund is wound up and dissolved.

We propose to require quarterly statements to be distributed within 45 days after the calendar quarter end. Based on our experience, we believe advisers generally would be in a position to prepare and deliver quarterly statements within this period.

An adviser generally would satisfy the proposed requirement to "distribute" the quarterly statements when the statements are sent to all investors in the private fund.<sup>99</sup> However, the proposed rule would preclude advisers from using layers of pooled investment vehicles in a control relationship with the adviser to avoid meaningful application of the distribution requirement. Advisers to private funds may from time to time establish special purpose vehicles ("SPVs") or other pooled vehicles for a variety of reasons, including facilitating investments by one or more private funds that the advisers manage. In circumstances where an investor is itself a pooled vehicle that is controlling, controlled by, or under common control with the adviser or its related persons (a "control relationship"), the adviser must look through that pool (and any pools in a control relationship with the adviser or its related persons, such as in a master-feeder fund structure), in order to send to investors in those pools. Without such a requirement, the adviser would be essentially delivering the quarterly statement to itself rather than to the parties the quarterly statement is designed to inform.<sup>100</sup> Outside of a control relationship, such as if the private fund investor is an unaffiliated fund of funds, this same concern is not

present, and the adviser would not need to look through the structure to make meaningful delivery. The adviser would just distribute the quarterly statement to the adviser or other designated party of the unaffiliated fund of funds. We believe that this approach would lead to meaningful delivery of the quarterly statement to the private fund's investors.

We request comment on the quarterly statement preparation and distribution requirement of the proposed rule:

- Should we require advisers to prepare and distribute statements to clients at least quarterly, or should we prescribe a different frequency? For example, should we require monthly, semi-annual, or annual statements? Should we mandate the same delivery frequency for all proposed statements under the rule? How would each of these approaches affect comparability and effectiveness of the information in those statements? Would a quarterly reporting obligation require advisers to value the fund's investments more frequently than advisers currently do?

- We understand that advisers may use a fund administrator or another person to distribute the quarterly statement. Is the proposed definition of "distribute" broad enough to capture a fund administrator or another person acting under the direction and control of the adviser sending the quarterly statement on the adviser's behalf? If not, should we broaden the definition? Instead of changing the definition of "distribute," should we require the adviser to distribute the quarterly statement, unless it has reason to believe that another person has distributed a required statement (and has a copy of each such statement distributed by such other person)?

- The proposed rule would require advisers to distribute the quarterly statement within 45 days of a calendar quarter end. Is this period too long or too short for an adviser to prepare the quarterly statement while also ensuring timely delivery to investors? Should we instead adopt a flexible delivery standard, such as a requirement that the adviser distribute the quarterly statement "promptly"? Why or why not? If we were to adopt a prompt delivery standard, should we define "promptly"? If so, how? If we should not define "promptly," should we instead interpret that term to mean as soon as reasonably practicable?

- We understand that preparing quarterly statements may require coordination with, and reliance on, third parties. This may be the case, for example, when a private fund itself invests in other private funds or

<sup>99</sup> See proposed rule 211(h)(1)-1 (defining "distribute"). For purposes of the proposed rules, any "in writing" requirement could be satisfied either through paper or electronic means consistent with existing Commission guidance on electronic delivery of documents. See Marketing Release, *supra* footnote 61, at n.346. If any distribution is made electronically for purposes of these proposed rules, it should be done in accordance with the Commission's guidance regarding electronic delivery. See *Use of Electronic Media by Broker Dealers, Transfer Agents, and Investment Advisers for Delivery of Information; Additional Examples Under the Securities Act of 1933, Securities Exchange Act of 1934, and Investment Company Act of 1940*, Release No. 34-37182 (May 9, 1996) [61 FR 24644 (May 15, 1996)].

<sup>100</sup> See proposed rule 211(h)(1)-1 (defining "control").

<sup>98</sup> See also ILPA Fee Reporting Template Guidance, Version 1.1 (Oct. 2016), at 6 (stating that "ILPA recommends that the Template is provided on a quarterly basis within a reasonable timeframe after the release of standard reports.").

portfolio companies. Should the rule allow different distribution timelines for different types of private funds (e.g., fund of funds, master feeder funds)? If so, why (e.g., do certain types of funds value assets more frequently than other types)? Should the proposed rule allow different distribution deadlines for underlying funds, depending on whether or not the underlying funds have the same adviser or an adviser that is a related person of the adviser distributing the quarterly statements?

- Should the proposed rule bifurcate the timing of when certain information in the quarterly statement is required? For example, should the proposed rule require fee and expense information starting at the fund's inception and then require performance information beginning later? If so, when should we require an adviser to start showing performance?

- Should the proposed rule treat liquid and illiquid funds differently with regard to fee and expense versus performance reporting? For example, should the proposed rule require liquid funds to start distributing quarterly statements with performance reporting sooner than illiquid funds? If so, why and how much sooner?

- As proposed, the rule would use "operating results" as the trigger for quarterly statement distribution. Should we instead rely on another trigger to indicate when an adviser must start distributing quarterly statements to investors? For example, should the proposed rule instead require an adviser to start distributing quarterly statements when the private fund has financial statements that report operating results? If so, why? Should we define "operating results" or clarify what it means?

- Should the proposed rule require an adviser to prepare and distribute an initial quarterly statement sooner than after the first two full calendar quarters of operating results? For example, should we require an adviser to prepare and distribute a quarterly statement after the first calendar quarter of the fund's operations? Why or why not? If we required an adviser to prepare and distribute a quarterly statement earlier in the fund's life, would this information be useful to investors?

- The proposed rule would require advisers to prepare and distribute a quarterly statement after the private fund has two full calendar quarters of operating results and continuously each calendar quarter thereafter. An adviser would be required to provide information for any stub periods that precede its first two full calendar quarters of operating results (*i.e.*, from the date of the fund's inception to the

beginning of the first calendar quarter during which the fund begins to produce operating results). Should the proposed rule explicitly address how advisers should handle stub periods? If so, how?

- The proposed rule would require fee and expense reporting based on a fund's calendar quarter and performance reporting based on a liquid fund's calendar year. Should we instead use "fiscal quarter" and "fiscal year"? Why or why not?

- Are there certain types of advisers or funds that should be exempt from distributing the quarterly statement to investors? If so, which ones and why? Are there certain types of advisers or funds that should be required to distribute quarterly statements to investors? If so, which ones and why?

- Instead of requiring advisers to distribute the quarterly statement to investors, should we require advisers to only distribute or make the quarterly statement available to investors upon request? Despite the limitations of private fund governance mechanisms, as discussed above, should we require advisers to distribute the quarterly statement to independent members of the fund's LPAC, board, or other similar governance body?

- Rule 206(4)–2 under the Advisers Act (the "custody rule") allows a client to designate an independent representative to receive on its behalf account statements and notices that are required by that rule.<sup>101</sup> Under the custody rule, an "independent representative" is defined as someone who does not control, is not controlled by, and is not under common control with the adviser, among other requirements.<sup>102</sup> Should we adopt a similar provision in the quarterly statement rule? Are there specific types of investors that need, or at present commonly designate, independent representatives to receive quarterly statements on their behalf?

- Should we revise the definition of "distribute" expressly to include distribution by granting investors access to a virtual data room containing the quarterly statement? Why or why not?

- We considered requiring the proposed quarterly statement disclosures to be submitted using a structured, machine-readable data language. Such format may facilitate comparisons of quarterly statement disclosures across advisers and periods. Should we require advisers to provide

quarterly statements in a machine-readable data language, such as Inline eXtensible Business Reporting Language ("Inline XBRL")? Why or why not? Would such a requirement make the quarterly statements, and the information included therein, easier for investors to analyze? For example, would it be useful for investors to download quarterly statement information directly into spreadsheets, particularly for institutional investors that may have a significant number of private fund investments? Would a machine-readable data language impose undue additional costs and burdens on advisers? Please provide support for your response, including, where available, cost data.

- If we adopt rules requiring a machine-readable data language, is the Inline XBRL standard the one that we should use? Are any other standards becoming more widely used or otherwise superior to Inline XBRL? What would the advantages of any such other standards be over Inline XBRL?

#### 4. Consolidated Reporting for Certain Fund Structures

An adviser may form multiple funds to implement a single strategy. For example, an adviser may form a parallel fund for certain tax-sensitive investors, such as non-U.S. investors that prefer to invest through an entity taxed as a corporation—rather than a partnership—for U.S. Federal income tax purposes, that invests alongside the main fund in all, or substantially all, of its investments. An adviser may also form a feeder fund for tax-sensitive investors that invests all, or substantially all, of its capital into the main fund. Advisers often seek to structure the funds in a way that accommodates investor preferences.

In some of these circumstances, we believe that consolidated reporting of the cost and performance information by all private funds in the structure would provide a more complete and accurate picture of the fees and expenses borne and performance achieved than reporting by each private fund separately. Due to the complexity of private fund structures, however, we believe a principles-based approach to the funds that must provide consolidated reporting is necessary. Accordingly, the proposed rule would require advisers to consolidate reporting for substantially similar pools of assets to the extent doing so would provide more meaningful information to the

<sup>101</sup> See rule 206(4)–2(a)(7) under the Advisers Act.

<sup>102</sup> See rule 206(4)–2(d)(4) under the Advisers Act.

private fund's investors and would not be misleading.<sup>103</sup>

For example, certain private funds utilize master-feeder structures. Typically, investors invest in onshore and offshore feeder funds, which, in turn, invest all, or substantially all, of their investable capital in a single master fund. The same adviser typically advises and controls all three funds, and the master fund typically makes and holds the investments. Because the feeder funds are conduits for investors to gain exposure to the master fund and its investments, the proposed rule would require the adviser to provide feeder fund investors with a single quarterly statement covering the applicable feeder fund and the feeder fund's proportionate interest in the master fund on a consolidated basis, so long as the consolidated statement would provide more meaningful information to investors and would not be misleading.

We request comment on the proposed consolidated reporting provision of the proposed rule:

- Do commenters agree that the proposed rule should require advisers to consolidate reporting to cover related funds to the extent doing so would provide more meaningful information to investors and would not be misleading? Alternatively, should we prohibit advisers from consolidating information for multiple funds? Why or why not? Should the rule permit, rather than require, consolidated reporting?

- Should we require advisers to provide a consolidated quarterly statement for funds that are part of the same strategy, such as parallel funds, feeder funds, and master funds? Alternatively, should these types of funds have separate reporting? For example, should feeder fund investors receive a quarterly statement covering the feeder fund and a separate quarterly statement covering the main fund or master fund? How should the rule address the fact that certain funds may have different expenses (e.g., an offshore fund may have director expenses while an onshore fund may not)? Should we require advisers to provide investors with a summary of any fund-specific expenses and the corresponding dollar amount(s)? Should such a requirement be triggered only if the fund-specific expense exceeds a certain threshold, such as a percentage of the fund size (e.g., .01%, .05%, or .10% of the fund's size) or a specific dollar amount (e.g., \$15,000, \$30,000, or \$50,000)?

- As noted above, the proposal would require advisers to provide feeder fund investors with a consolidated quarterly statement covering the applicable feeder fund and the feeder fund's proportionate interest in the master fund, to the extent doing so would provide more meaningful information to investors and would not be misleading. Do commenters agree with this approach? Alternatively, should we require advisers to provide consolidated reporting covering all feeder funds (and not just the applicable feeder fund) and the master fund? Why or why not?

- We also recognize that certain private funds have multiple classes (or other groupings such as series or tranches) of interests or shares. The proposed rule would require the quarterly statement to present fund-wide information. Would advisers face challenges in calculating fee, expense, and performance information if there are differences in fees, allocations, and/or expenses between or among classes, series, or tranches? Should we require disclosure of class-specific fees and expenses, or of the differences among classes? Why or why not? Should we instead permit or require quarterly statements for multi-class private funds to present the proposed fee and expense and performance information on a class-by-class basis, particularly if each class (or series or tranche) is considered a distinct private fund or separate legal entity (with segregated assets and liabilities) under applicable law? Would such an approach provide more meaningful information for investors in each of those classes, given the potential for different fee, allocation, and expense structures? Should we require quarterly statements for multi-class (or multi-series or multi-tranche) private funds to present class-by-class (or series-by-series or tranche-by-tranche) information to the extent each class (or series or tranche) holds different investments?

- Should advisers only be required to distribute a class' quarterly statement to interest holders of such class, or should all fund investors be entitled to receive such statement regardless of whether they are interest holders of the relevant class if the rule permits or requires class-specific quarterly statements for multi-class private funds?

- Certain advisers provide combined financial statements covering multiple funds. Should we require or permit advisers to provide consolidated quarterly statements for funds that have combined financial statements? Why or why not?

## 5. Format and Content Requirements

The proposed rule would require the adviser to use clear, concise, plain English in the quarterly statement.<sup>104</sup> For example, an adviser would not satisfy the proposed requirement for "clear" disclosures unless those disclosures are made in a font size and type that is legible, and margins and paper size (if applicable) are reasonable. Likewise, to meet this standard, any information that an adviser chooses to include in a quarterly statement, but that is not required by the rule, would be required to be as short as practicable, not more prominent than the required information, and not obscure or impede an investor's understanding of the mandatory information.

In addition, the proposed rule would require an adviser to present information in the quarterly statement in a format that facilitates review from one quarterly statement to the next. As noted above, the quarterly statement is designed to allow an investor to monitor and assess the costs and performance of the fund over time. We anticipate that, quarter-over-quarter, an adviser would use a consistent format for a fund's quarterly statements, thus allowing an investor to easily compare fees, expenses, and performance over each quarterly period. We also encourage advisers to use a structured, machine-readable format if advisers believe this format would be useful to the investors in their fund.

The proposed format and content requirements would apply to all aspects of a quarterly statement, including the proposed requirements to disclose the manner in which expenses, payments, allocations, rebates, waivers, and offsets are calculated and to cross-reference sections of the private fund's organizational and offering documents.<sup>105</sup> We believe this approach would improve the utility of the quarterly statement by making it easier for investors to review and analyze. These requirements would support an investor's ability to understand needed context provided in the quarterly statement regarding fees, expenses, and performance that allows investors to monitor their investments. For example, providing investors with clear and easily accessible cross-references to the fund governing documents would make it easier for the investor to monitor whether the fees and expenses in the quarterly statement comply with the fund's governing documents.

We believe the proposal strikes an appropriate balance in prescribing the

<sup>103</sup> See proposed rule 211(h)(1)–2(f). See also *infra* Section II.E.

<sup>104</sup> Proposed rule 211(h)(1)–2(g).

<sup>105</sup> Proposed rule 211(h)(1)–2(d).

content of the tables and performance information to be included in quarterly statements while taking a fairly principles-based approach to format. This would help provide investors with standardized information about their private fund investments, while affording advisers some flexibility to present the required information without being overly prescriptive or sacrificing readability. We considered, but are not proposing, to further standardize format, because we recognize this might result in investor confusion if an adviser includes inapplicable line items to satisfy our form requirements, while omitting additional relevant information that might be unique to a particular fund. Moreover, we were concerned that advisers would be unable to report on a consolidated basis if we further prescribed the format of the statements.

We request comment on this aspect of the proposed rule:

- Should the proposed quarterly statement rule include a provision on formatting and content? Why or why not?
- Do commenters agree with the flexibility of the proposed format and content requirements, or should we prescribe wording? For example, should we require a cover page with prescribed wording? If so, what prescribed wording should we require?
- To meet the rule's formatting requirements, any information that an adviser chooses to include in a quarterly statement, but that is not required by the rule, would be required to be presented in a manner that is no more prominent than the required information. Should the rule, instead, require that advisers *more* prominently present information that is required by the proposed quarterly statement rule (as opposed to supplemental information that is merely permitted)? If an adviser chooses to include supplemental information, should we require that adviser to disclose what information in the quarterly statement is required versus that which is voluntary?

## 6. Recordkeeping for Quarterly Statements

We propose amending rule 204–2 (the “books and records rule”) under the Advisers Act to require advisers to retain books and records related to the proposed quarterly statement rule.<sup>106</sup>

<sup>106</sup> For all of the recordkeeping rule amendments in this proposed rulemaking package, advisers would be required to maintain and preserve the record in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office

These proposed amendments would help facilitate the Commission's inspection and enforcement capabilities. First, we propose to require private fund advisers to retain a copy of any quarterly statement distributed to fund investors pursuant to the proposed quarterly statement rule, as well as a record of each addressee, the date(s) the statement was sent, address(es), and delivery method(s). Second, we propose to require advisers to retain all records evidencing the calculation method for all expenses, payments, allocations, rebates, offsets, waivers, and performance listed on any quarterly statement delivered pursuant to the proposed quarterly statement rule. Third, advisers would be required to make and keep books and records substantiating the adviser's determination that the private fund it manages is a liquid fund or an illiquid fund pursuant to the proposed quarterly statement rule. We believe these proposed requirements would facilitate our staff's ability to assess an adviser's compliance with the proposed rule and would similarly enhance an adviser's compliance efforts.<sup>107</sup>

We request comment on the proposed recordkeeping rule amendments:

- Should we require advisers to maintain the proposed records or would these requirements be overly burdensome for advisers? Are there alternative or additional recordkeeping requirements we should impose?
- Should we require advisers to retain a record of each addressee, the date(s) the statement was sent, address(es), and delivery method(s) for each quarterly statement, as proposed? Should we instead eliminate this requirement because of the potential burdens?
- Should we provide more specific requirements regarding the records an adviser must maintain to substantiate its determination that a private fund is a liquid fund or an illiquid fund? Alternatively, should we leave the proposed rule as is and allow advisers flexibility in how they document this determination?

## B. Mandatory Private Fund Adviser Audits

In addition to disclosure, we propose to require private fund advisers to obtain an annual audit of the financial

of the investment adviser. *See* rule 204–2(e)(1) under the Advisers Act.

<sup>107</sup> Advisers already are required to retain performance calculation information under the existing books and records rule and therefore would be required to retain the performance calculation information required as part of the proposed quarterly statement rule. *See* rule 204–2(a)(16) under the Advisers Act (requiring advisers to retain performance calculation information).

statements of the private funds they manage.<sup>108</sup> In addition to providing protection for the fund and its investors against the misappropriation of fund assets, we believe an audit by an independent public accountant would provide an important check on the adviser's valuation of private fund assets, which often serve as the basis for the calculation of the adviser's fees.

The proposed audit rule would require a registered investment adviser providing investment advice, directly or indirectly, to a private fund, to cause that fund to undergo a financial statement audit that meets the terms of the rule at least annually and upon liquidation, unless the fund otherwise undergoes such an audit. Under the proposed rule:

(1) The audit must be performed by an independent public accountant that meets the standards of independence in 17 CFR 210.2–01(b) and (c) (rule 2–01(b) and (c) of Regulation S–X) that is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board (“PCAOB”) in accordance with its rules;

(2) The audit must meet the definition of audit in 17 CFR 210.1–02(d) (rule 1–02(d) of Regulation S–X), the professional engagement period of which shall begin and end as indicated in Regulation S–X rule 2–01(f)(5);

(3) Audited financial statements must be prepared in accordance with U.S. Generally Accepted Accounting Principles (“U.S. GAAP”) or, in the case of financial statements of private funds organized under non-U.S. law or that have a general partner or other manager with a principal place of business outside the United States (“foreign private funds”), must contain information substantially similar to statements prepared in accordance with U.S. GAAP and material differences with U.S. GAAP must be reconciled;

(4) Promptly after completion of the audit, the private fund's audited financial statements, which include any reconciliation to U.S. GAAP prepared for a foreign private fund, are distributed; and

(5) The auditor notifies the Commission upon certain events.<sup>109</sup>

Additionally, for a fund that the adviser does not control and that is neither controlled by nor under

<sup>108</sup> Proposed rule 206(4)–10. The proposed rule would apply to all investment advisers registered, or required to be registered, with the Commission.

<sup>109</sup> Proposed rule 206(4)–10; proposed rule 211(h)(1)–1 (defining “control” and “distributed”).

common control with the adviser (e.g., where an unaffiliated sub-adviser provides services to the fund), such adviser would only need to take all reasonable steps to cause the fund to undergo an audit that would meet these elements.

We have historically relied on financial statement audits to verify the existence of pooled investment vehicle investments.<sup>110</sup> Financial statement audits also provide additional meaningful protections to private fund investors by increasing the likelihood that fraudulent activity or problems with valuation are uncovered, thereby providing deterrence against fraudulent conduct by fund advisers. For example as noted above, a fund's adviser may use a high level of discretion and subjectivity in valuing a private fund's illiquid investments, which are difficult to value. This creates a conflict of interest if the adviser also calculates its fees as a percentage of the value of the fund's investments and/or an increase in that value (net profit), as is typically the case. Moreover, private fund advisers often rely heavily on existing fund performance when obtaining new investors (in the case of a private fund that makes continuous or periodic offerings) or fundraising for a new fund. These factors raise the possibility that funds are valued opportunistically and that the adviser's compensation may involve fraud or deception, resulting in an inappropriate compensation scheme.<sup>111</sup> A fund audit includes the evaluation of whether the fair value

estimates and related disclosures are reasonable and consistent with the requirements of the financial reporting framework (e.g., U.S. GAAP), which may include evaluating the selection and application of methods, significant assumptions, and data used by the adviser in making the estimate.<sup>112</sup> We believe that this would provide a critical set of additional protections by an independent third party.

The proposed audit rule is based on the custody rule and contains many similar or identical requirements, although compliance with either rule would not automatically satisfy the requirements of the other.<sup>113</sup> Although the financial statement audit performed under either rule would be the same, there are several differences between the two rules. The most notable difference between the two rules is the lack of choice about obtaining an audit under the proposed audit rule. Under the custody rule, an adviser is deemed to have satisfied that rule's annual surprise examination requirement for a pooled investment vehicle client if that pool is subject to an annual financial statement audit by an independent public accountant, and its audited financial statements (prepared in accordance with generally accepted accounting principles) are distributed to the pool's investors. Accordingly, an adviser may obtain a surprise examination under the custody rule instead of an audit. Private fund advisers complying with the proposed audit rule would not have a similar choice; they must obtain an audit. Based on our experience since introducing the custody rule's audit provision, we have come to believe that audits provide substantial benefits to private funds and their investors because audits test assertions associated with the investment portfolio (e.g., completeness, existence, rights and obligations, valuation, presentation). Audits may also provide a check against adviser misrepresentations of performance, fees, and other information about the fund. Accordingly, the proposed audit rule would require registered private fund advisers, including those that currently opt to undergo a surprise examination for custody rule compliance purposes, to have their private fund clients undergo a financial statement audit.

Another main difference between the requirements of the two rules is the requirement of the proposed rule for

there to be a written agreement between the adviser or the private fund and the auditor pursuant to which the auditor would be required to notify our Division of Examinations upon the auditor's termination or issuance of a modified opinion.<sup>114</sup> There is not a similar obligation under the custody rule for an adviser that relies on the audit provision to satisfy the surprise examination requirement. Our experience in receiving similar information from accountants who perform surprise examinations under the custody rule has led us to conclude that timely receipt of this information—from an independent third party—would more readily enable our staff to identify advisers potentially engaged in harmful misconduct and who have other compliance issues.<sup>115</sup> This also would aid the Commission in its oversight of private fund advisers.

The other main difference between the two rules, aside from timing requirements for the distribution of audited financial statements under the two rules discussed below, relates to their scope. While both rules pertain to advisers that are registered or required to be registered with us, the custody rule also contains exceptions to the surprise examination requirement, which in turn make it unnecessary for an adviser to rely on that rule's audit provision.<sup>116</sup> In light of the different policy goals of these two rules, we are not proposing a parallel exception to the proposed audit rule. Moreover, in our experience, private fund advisers generally do not often rely on these exceptions. The proposed audit rule does, however, contain an exception in certain contexts where the adviser takes all reasonable steps to cause an audit, as described and for reasons discussed below, which does not exist in the custody rule.

#### 1. Requirements for Accountants Performing Private Fund Audits

The proposed audit rule would include certain requirements regarding the accountant performing a private fund audit. First, we propose to require an accountant performing a private fund audit to meet the standards of

<sup>110</sup> See, e.g., rule 206(4)–2(b)(4) under the Advisers Act; *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2176 (Sept. 25, 2003) [68 FR 56692 (Oct. 1, 2003)] (“Custody Release”) (providing advisers to certain pooled investment vehicles with an exception to the surprise examination requirement if the pooled investment vehicles undergo an audit). Not all advisers are subject to the custody rule and even those that are subject to the custody rule are not required to obtain an audit in order to comply with the rule.

<sup>111</sup> See generally Jenkinson, Sousa, Stucke, How Fair are the Valuations of Private Equity Funds? (2013), available at <https://www.psers.pa.gov/About/Investment/Documents/PPMAIRC%202018/27%20How%20Fair%20are%20the%20Valuations%20of%20Private%20Equity%20Funds.pdf>. See also *In the Matter of Swapnil Rege*, Investment Advisers Act Release No. 5303 (July 18, 2019) (settled action) (alleging that an employee of a private fund adviser mispriced the private fund's investments, which resulted in the adviser charging the fund excess management fees); *SEC v. Southridge Capital Mgmt., LLC*, Lit. Rel. No. 21709 (Oct. 25, 2010) (alleging that adviser overvalued the largest position held by the funds by fraudulently misstating the acquisition price of the assets); see docket for *SEC v. Southridge Capital Mgmt., LLC*, U.S. District Court, District of Connecticut (New Haven), case no. 3:10–CV–01685 (on September 12, 2016 the court granted the SEC's motion for summary judgment and entered a final judgment in favor of the SEC in 2018).

<sup>112</sup> See American Institute of Certified Public Accountants' (“AICPA”) auditing standards, AU–C Section 540 and PCAOB auditing standards, AS 2501.

<sup>113</sup> See rule 206(4)–2(b)(4) under the Advisers Act.

<sup>114</sup> See proposed rule 206(4)–10(e). See AICPA auditing standard, AU–C Section 705, which establishes three types of modified opinions: A qualified opinion, an adverse opinion, and a disclaimer of opinion.

<sup>115</sup> See rule 206(4)–2(a)(4)(iii) (requiring somewhat similar information in the context of a surprise examination).

<sup>116</sup> See rule 206(4)–2(b)(3) and (6) (providing exceptions from the surprise examination requirement for fee deduction and where the adviser has custody solely because a related person has custody of a client's funds or securities).

independence described in rule 2–01(b) and (c) of Regulation S–X in support of the Commission’s long-standing recognition that an audit by an objective, impartial, and skilled professional contributes to both investor protection and investor confidence.<sup>117</sup> Second, the proposed rule would require the independent public accountant performing the audit to be registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the PCAOB in accordance with its rules. Based on our experience with the custody rule, we believe registration and the periodic inspection of an independent public accountant’s system of quality control by the PCAOB provide investors with confidence in the quality of the audits produced under the proposed rule.

We understand that this requirement may limit the pool of accountants that are eligible to perform these services because only those accountants that currently conduct public company issuer audits are subject to regular inspection by the PCAOB. Most private funds, however, are already undergoing a financial statement audit; therefore, the increase in demand for these services may be limited.<sup>118</sup> Nonetheless, the resulting competition for these services might increase costs to investment advisers and investors.

We understand that, as part of a temporary inspection program, the PCAOB inspects accountants auditing brokers and dealers, and identifies and addresses with these firms any significant issues in those audits.<sup>119</sup> Similar to the inspection program for issuer audits, we believe that the temporary inspection program for broker-dealers provides valuable oversight of these accountants, resulting in better quality audits. Accordingly, we would consider an accountant’s compliance with the PCAOB’s temporary inspection program for auditors of brokers and dealers to satisfy

the requirement for regular inspection by the PCAOB under the proposed independent public accountant engagements provision until the effective date of a permanent program for the inspection of broker and dealer auditors that is approved by the Commission.<sup>120</sup>

An independent public accounting firm would not be considered to be “subject to regular inspection” if it is included on the list of firms that is headquartered or has an office in a foreign jurisdiction that the PCAOB has determined it is unable to inspect or investigate completely because of a position taken by one or more authorities in that jurisdiction in accordance with PCAOB Rule 6100.<sup>121</sup> We recognize that there may be a limited number of PCAOB-registered and inspected independent public accountants in certain foreign jurisdictions. However, we do not believe that advisers would have significant difficulty in finding an accountant that is eligible under the proposed rule in most jurisdictions because many PCAOB-registered independent public accountants who are subject to regular inspection currently have practices in various jurisdictions, which may ameliorate concerns regarding offshore availability.

## 2. Auditing Standards for Financial Statements

Under the proposed audit rule, an audit must meet the definition in rule 1–02(d) of Regulation S–X. Pursuant to that definition, financial statement audits performed for purposes of the proposed audit rule would generally be performed in accordance with the generally accepted auditing standards of the United States (“U.S. GAAS”).<sup>122</sup>

<sup>120</sup> Our staff took a similar position and has had several years to observe the impact on the availability of accountants to perform services and the quality of services produced by these accountants. See Robert Van Grover Esq., Seward & Kissel LLP, SEC Staff No-Action Letter (Dec. 11, 2019) (extending the no-action position taken in prior letters until the date that a PCAOB-adopted permanent program, having been approved by the Commission, takes effect).

<sup>121</sup> See, e.g., HFCAA Determination Report Pursuant to 15 U.S.C. 7214(i)(2)(A) and PCAOB Rule 6100 (Dec. 16, 2021), PCAOB Release No. 104–HFCAA–2021–001, available at [104-hfcaa-2021-001.pdf](https://www.hfcaa.gov/104-hfcaa-2021-001.pdf) (azureedge.net) (publishing such list of firms as of December 2021).

<sup>122</sup> Under the definition in rule 1–02(d) of Regulation S–X, an “audit” of an entity (such as a private fund) that is not an issuer as defined in section 2(a)(7) of the Sarbanes-Oxley Act of 2007 means an audit performed in accordance with either the generally accepted auditing standards of the United States (“U.S. GAAS”) or the standards of the PCAOB. When conducting an audit of financial statements in accordance with the standards of the PCAOB, however, the auditor would also be required to conduct the audit in

U.S. GAAS requires that an auditor evaluate and respond to the risk of material misstatements of the financial statements due to fraud or error.<sup>123</sup> Among other benefits of this standard, audits performed in accordance with U.S. GAAS would help detect valuation irregularities or errors, as well as an investment adviser’s loss, misappropriation, or misuse of client investments. The proposed rule would require the professional engagement period of an audit performed under the rule to begin and end as indicated in Regulation S–X rule 2–01(f)(5).<sup>124</sup>

## 3. Preparation of Audited Financial Statements

The proposed rule also generally would require the audited financial statements to be prepared in accordance with U.S. GAAP. Financial statements of private funds organized under non-U.S. law or that have a general partner or other manager with a principal place of business outside the United States would be required to contain information substantially similar to statements prepared in accordance with U.S. GAAP and any material differences would be required to be reconciled to U.S. GAAP. Requiring that financial statements comply with U.S. GAAP is designed to help investors receive consistent and quality financial reporting on their investments from the fund’s adviser.

Financial statements that are prepared in accordance with accounting standards other than U.S. GAAP, would meet the requirements of the proposed audit rule so long as they contain information substantially similar to financial statements prepared in accordance with U.S. GAAP, material differences with U.S. GAAP are reconciled, and the reconciliation,

accordance with U.S. GAAS because the audit would not be within the jurisdiction of the PCAOB as defined by the Sarbanes-Oxley Act of 2002, as amended, (*i.e.*, not an issuer, broker, or dealer). See AICPA auditing standards, AU–C Section 700.46. We believe most advisers would choose to perform the audit pursuant to U.S. GAAS only rather than both standards, though it would be permissible under the proposed audit rule to perform the audit pursuant to both standards.

<sup>123</sup> See AICPA auditing standards, AU–C Section 240. Audits performed under PCAOB standards provide similar benefits. See PCAOB auditing standards, AS 2401, which discusses consideration of fraud in a financial statement audit.

<sup>124</sup> Among other things, rule 2–01(f)(5) of Regulation S–X indicates that the professional engagement period begins at the earlier of when the accountant either signs an initial engagement letter (or other agreement to review or audit a client’s financial statements) or begins audit, review, or attest procedures; and the period ends when the audit client or the accountant notifies the Commission that the client is no longer that accountant’s audit client.

<sup>117</sup> See *Revision of the Commission’s Auditor Independence Requirements*, Release No. 33–7919 (Nov. 21, 2000) [65 FR 76008 (Dec. 5, 2000)]. The custody rule requires all accountants performing services to meet the standards of independence described in rule 2–01(b) and (c) of Regulation S–X. See rule 206(4)–2(d)(3) under the Advisers Act.

<sup>118</sup> For example, more than 90 percent of the total number of hedge funds and private equity funds currently undergo a financial statement audit. See *infra* Section V.B.4.

<sup>119</sup> See PCAOB Adopts Interim Inspection Program for Broker-Dealer Audits and Broker and Dealer Funding Rules (June 14, 2011) (“temporary inspection program”), available at [https://pcaobus.org/News/Releases/Pages/06142011\\_OpenBoardMeeting.aspx](https://pcaobus.org/News/Releases/Pages/06142011_OpenBoardMeeting.aspx). See also Dodd-Frank Act Section 982.

including supplementary U.S. GAAP disclosures, is distributed to investors as part of the audited financial statements.<sup>125</sup> We believe that this approach would allow advisers flexibility to provide investors with financial statements that are prepared in accordance with applicable accounting standards. We believe a reconciliation to U.S. GAAP is necessary for private fund audits because U.S. GAAP, has industry specific accounting principles for certain pooled vehicles, including private funds.<sup>126</sup> As a result, there could be material differences between other accounting standards and U.S. GAAP, for example in the presentation of a trade/settlement date, schedule of investments and financial highlights, that we would require to be reconciled.

#### 4. Prompt Distribution of Audited Financial Statements

The proposed audit rule would require a fund's audited financial statements to be distributed to current investors "promptly" after the completion of the audit.<sup>127</sup> The audited financial statements would consist of the applicable financial statements (including any required reconciliation to U.S. GAAP, including supplementary U.S. GAAP disclosures), related schedules, accompanying footnotes, and the audit report. We considered but are not proposing to require the audited financials to be distributed within 120 days of a private fund's fiscal year end, similar to the approach under the custody rule. Based on our experience administering the custody rule, we believe that a 120-day time period is generally appropriate to allow the financial statements of an entity to be audited and to provide investors with timely information. We also understand, however, that preparing audited financial statements for some arrangements, such as fund of funds arrangements, may require reliance on third parties, which could cause an adviser to fail to meet the 120-day timing requirements for distributing audited financial statements regardless of actions it takes to meet the

requirements. We also recognize there may be times when an adviser reasonably believes that a fund's audited financial statements would be distributed within the required timeframe but fails to have them distributed in time under certain unforeseeable circumstances. For example, during the COVID-19 pandemic, some advisers were unable to deliver audited financial statements in the timeframes required under the custody rule due to logistical disruptions. Accordingly, and in light of the fact that there is not an alternative method by which to satisfy the proposed rule as there is under the custody rule (*i.e.*, undergo a surprise examination), we would require the audited financial statements to be distributed "promptly," rather than pursuant to a specific deadline. This would provide some flexibility without affecting investor protection.

Under the proposed audit rule, the audited financial statements (including any reconciliation to U.S. GAAP prepared for a foreign private fund, as applicable) must be sent to all of the private fund's investors. In circumstances where an investor is itself a pooled vehicle that is in a control relationship with the adviser or its related persons, it would be necessary to look through that pool (and any pools in a control relationship with the adviser or its related persons, such as in a master-feeder fund structure), in order to send to investors in those pools.<sup>128</sup> Without such a requirement, the audited financial statements would essentially be delivered to the adviser rather than to the parties the financial statements are designed to inform. Outside of a control relationship, such as if the private fund investor is an unaffiliated fund of funds, this same concern is not present, and it would not be necessary to look through the structure to make meaningful delivery. It would be sufficient to distribute the audited financial statements to the adviser to, or other designated party of, the unaffiliated fund of funds. We believe that this approach would lead to meaningful delivery of the audited financial statements to the private fund's investors.

#### 5. Annual Audit, Liquidation Audit, and Audit Period Lengths

Key to the effectiveness of the audit in protecting investors is timely and regular administration and distribution. Under the proposed audit provision, an audit must be obtained at least annually

and upon an entity's liquidation. The liquidation audit would serve as the annual audit for the fiscal year in which it occurs. Requiring the audit on an annual basis and at liquidation would help alert investors within months, rather than years, to any material misstatements identified in the audit and would raise the likelihood of mitigating losses or reducing exposure to other investor harms. Similarly, a liquidation audit would help ensure the appropriate and prompt accounting of the proceeds of a liquidation so that investors can take timely steps to protect their rights at a time when they may be vulnerable to misappropriation by the investment adviser. We believe that it becomes increasingly difficult to correct a material misstatement the longer it goes undetected. The proposed annual and liquidation audit requirements would address these concerns while also balancing the cost, burden, and utility of requiring frequent audits.

The proposed annual audit requirement is consistent with current practices of private fund advisers that obtain an audit in order to comply with the custody rule under the Advisers Act, or to satisfy investor demand for an audit, and would provide investors with uniformity in the information they are receiving.<sup>129</sup> When an investor receives audited financial statements each year from the same private fund, the investor can compare statements year-over-year. Additionally, the investor can analyze and compare audited financial statements across other private funds and similar investment vehicles each year. Further, we believe investors expect audited financial statements to include 12-month periods and rely on this uniform period to review and analyze financial statements year over year for the same private fund.

With respect to liquidation, we understand that the amount of time it takes to complete the liquidation of a private fund may vary. A number of years might elapse between the decision to liquidate an entity and the completion of the liquidation process. During this time, the fund may execute few transactions and the total amount of investments may represent a fraction of the investments that existed prior to the start of the liquidation process. We further understand that a lengthy liquidation period can lead to circumstances where the cost of an annual audit represents a sizeable portion of the fund's remaining assets.

<sup>125</sup> Proposed rule 206(4)–10(c) and (d). *See also* Custody Release, *supra* footnote 110, at n.41 (stating that an adviser may use such financial statements to qualify for the audit exception from the custody rule with respect to pools that have a place of organization outside the United States or a general partner or other manager with a principal place of business outside the United States, if such financial statements contain information that is substantially similar to financial statements prepared in accordance with U.S. GAAP and contain a footnote reconciling any material variations between such comprehensive body of accounting standards and U.S. GAAP).

<sup>126</sup> *See* U.S. GAAP ASC 946.

<sup>127</sup> Proposed rule 206(4)–10(d).

<sup>128</sup> *See* proposed rule 211(h)(1)–1 (defining "control" and "distribute").

<sup>129</sup> As discussed above, differences between the two rules are unrelated to the financial statement audit itself.



While we considered additional modifications to the audit requirement for a private fund during liquidation, we are concerned that allowing for less frequent auditing (e.g., every 18 months or two years) during an entity's liquidation may expose investors to abuse that could then go unnoticed for prolonged periods. Furthermore, it is our understanding that allowing for less frequent auditing during liquidation—for example, requiring an audit every two years in such circumstances—may not necessarily result in a meaningful cost reduction to advisers or investors.

#### 6. Commission Notification

The proposed rule would require an adviser to enter into, or cause the private fund to enter into, a written agreement with the independent public accountant performing the audit to notify the Commission (i) promptly upon issuing an audit report to the private fund that contains a modified opinion and (ii) within four business days of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed.<sup>130</sup> The accountant making such a notification would be required to provide its contact information and indicate its reason for sending the notification. The written agreement must require the independent public accountant to notify the Commission by electronic means directed to the Division of Examinations. Timely receipt of this information would enable our staff to evaluate the need for an examination of the adviser. We expect the Division of Examinations would establish a dedicated email address to receive these confidential transmissions and would make the address available on the Commission's website in an easily retrievable location.

As we noted above, there is not a similar obligation under the custody rule for an accountant to notify the Commission as there is for a surprise examination, although there is a requirement on Form ADV for a private fund adviser *itself* to report to the Commission whether it received a qualified audit opinion and to provide, and update, its auditor's identifying information.<sup>131</sup> However, our experience in receiving notifications from accountants who perform surprise examinations under the custody rule has led us to conclude that timely receipt of this information—from an independent third party—would more readily enable our staff to identify

advisers potentially engaged in harmful misconduct and who have other compliance issues. This would bolster the Commission's efforts at preventing fraudulent, deceptive, and manipulative activity and would aid oversight of private fund advisers.

#### 7. Taking All Reasonable Steps To Cause an Audit

We recognize that some advisers may not have requisite control over a private fund client to cause its financial statements to undergo an audit in a manner that would satisfy all five elements (paragraphs (a) through (e)) of the proposed rule. This could be the case, for instance, where a sub-adviser is unaffiliated with the fund. Therefore, we are proposing to require that an adviser *take all reasonable steps* to cause its private fund client to undergo an audit that would satisfy the rule, so long as the adviser does not control the private fund and is neither controlled by nor under common control with the fund.<sup>132</sup> What would constitute “all reasonable steps” would depend on the facts and circumstances. For example, a sub-adviser that has no affiliation to the general partner of a private fund that did not obtain an audit could document the sub-adviser's efforts by including (or seeking to include) the requirement in its sub-advisory agreement. On the contrary, if the adviser is the primary adviser to the fund, even if it is not the general partner or a related person of the general partner, it would likely not be reasonable for the fund not to be audited in accordance with the rule.

#### 8. Recordkeeping Provisions Related to the Proposed Audit Rule

Finally, the proposal would amend the Advisers Act books and records rule to require advisers to keep a copy of any audited financial statements, along with a record of each addressee and the corresponding date(s) sent, address(es), and delivery method(s) for each such addressee.<sup>133</sup> Additionally, the adviser would be required to keep a record documenting steps taken by the adviser to cause a private fund client with which it is not in a control relationship to undergo a financial statement audit that would comply with the rule. This aspect of the proposal is designed to facilitate our staff's ability to assess an adviser's compliance with the proposed audit rule and to detect risks the proposed audit rule is designed to address. We believe it would similarly

enhance an adviser's compliance efforts as well.

We request comment on all aspects of the proposed audit rule and related proposed amendments to the books and records rule, including the following items:

- Would the proposed audit rule provide appropriate protection for investors? If not, please describe what, if any, modifications would improve investor protection.
- The proposed audit rule bears many similarities to provisions of the custody rule; however, one notable difference is that there would be no option to, instead, undergo a surprise examination and rely on a qualified custodian to deliver quarterly statements. What would be the impact on advisers to private funds that are not relying on the custody rule's audit provision? Are private funds undergoing similar audits of their financial statements for other reasons, or would this represent a new requirement for them? There also are no exceptions from the proposed rule, as there are in the custody rule, such as the exception from the surprise examination requirement for advisers whose sole basis for being subject to the rule is because they have authority to deduct their advisory fees. What would be the impact on advisers to private funds that are relying on this and other exceptions? Do many private fund advisers rely on the exception for fee-deduction?
- Do commenters agree that the similarities of the audit requirements for the custody rule and for the proposed rule would ease the compliance burdens of advisers that would be required to comply with both? Should the rule provide that compliance with one rule would satisfy the requirements of the other, given the similarities of the two rules? Why or why not?
- The application of the proposed rule to registered advisers to private funds seeks to balance our policy goal with the anticipated costs of the proposed measures. Do commenters agree with this approach? If not, what would be a more effective way of achieving our goals?
- Should the rule apply to *all* advisers to private funds, rather than to just advisers to private funds that are registered or are required to be registered? Should it apply to exempt reporting advisers? Why or why not?
- Similarly, should it apply in the context of all pooled investment vehicle clients (e.g., funds that rely on section 3(c)(5) of the Investment Company Act), rather than just in the context of those that meet the Advisers Act definition of private fund? Should it apply more broadly to any advisory account with

<sup>132</sup> Proposed rule 206(4)–10(f).

<sup>133</sup> Proposed rule 204–2(a)(21). See also *supra* footnote 106 (describing the record retention requirements under the books and records rule).

<sup>130</sup> Proposed rule 206(4)–10(e).

<sup>131</sup> Form ADV Part 1A, Section 7.B.1, Q.23.

financial statements that can be audited? Why or why not?

- Should the rule provide any full or partial exceptions, such as when an adviser plays no role in valuing the fund's assets, receives little or no compensation for its services, or receives no compensation based on the value of the fund's assets? Should the rule provide exceptions for private funds below a certain asset threshold (e.g., less than \$5 million)? A higher or lower amount? Should the rule provide exemptions for private funds that have only related person investors, or that have a limited number of investors, such as 5 or fewer investors? If yes, please identify which advisers or funds we should except, from which aspects of the proposed audit rule, and why.
- Should the rule apply to a sub-adviser to a private fund? In situations where a fund has multiple advisers, is it clear that a single audit of the fund's financial statements may satisfy the proposed audit rule for all of the advisers subject to the rule?
- Should the alternative of "taking all reasonable steps" to cause a private fund client to be audited apply in *any* situation, rather than just in situations where the adviser is not in a control relationship with its fund client? Why or why not? Is it sufficiently clear how an investment adviser can establish that it has "taken all reasonable steps" to cause a private fund client to obtain an audit?
- Should the rule require accountants performing the independent public audits to be registered with the PCAOB, as proposed? Should the rule limit the pool of accountants to those who are subject to inspection by the PCAOB, as proposed? If the rule does not include these requirements, should the rule impose any alternative or additional requirements on such accountants? If so, describe these additional requirements and explain why they are necessary or appropriate.
- Do commenters agree that the availability of accountants to perform services for purposes of the proposed audit rule is sufficient and that even advisers in foreign jurisdictions (or with private fund clients in foreign jurisdictions) would not have significant difficulty in finding a local accountant that is eligible to perform an audit under the proposed rule? Do advisers have reasonable access to independent public accountants that are registered with, and subject to inspection by, the PCAOB in the foreign jurisdictions in which they operate? If not, how should the rule address this issue?
- Should the rule require advisers to obtain audits performed under rule 1–

02(d) of Regulation S–X, as proposed? If not, what other auditing standards should the rule allow? Are there certain non-U.S. auditing standards that the proposed rule should explicitly include?

- Should the rule require private funds to prepare audited financial statements in accordance with generally accepted accounting principles, as proposed? Should the rule include any additional requirements regarding the preparation of financial statements? If so, what requirements, and why?
- As proposed, should financial statements prepared in accordance with accounting standards other than U.S. GAAP for foreign private funds meet the requirements of the rule provided they contain information substantially similar to statements prepared in accordance with U.S. GAAP, material differences with U.S. GAAP are reconciled, and the reconciliation is distributed to investors along with the financial statements? If so, should we specify what "substantially similar" means?
- Would there be unique challenges to complying with the rule for auditors and advisers to private funds in foreign jurisdictions? For example, might certain advisers or auditors face challenges in complying with the proposed rule's Commission notification requirement, including because of applicable privacy and other local laws? If so, what would alleviate these challenges and still achieve the policy goals of the proposed audit rule?
- Do commenters agree that the proposed rule's requirement to distribute the audited financial statements promptly would provide appropriate flexibility regarding the timing of the distribution of audited financial statements? Should there nevertheless be an outer limit on the number of days an investment adviser has from its fiscal year end for the distribution of audited financial statements? If so, what should that limit be? Would it be more appropriate for distribution to be required within 120 days of the end of the fund's fiscal year, as under the custody rule? Alternatively, would a longer or shorter period be appropriate in most circumstances? Should the timeline for distributing audited financial statements align with the timeline for distributing quarterly statements under the proposed quarterly statement rule? Why or why not? We understand that funds of funds or certain funds in master-feeder structures (including those advised by related persons) have difficulty satisfying the 120-day requirement and that our staff has indicated they would

not recommend enforcement if certain of these funds satisfy the distribution requirement within 180 or 260 days of the fund's fiscal year end, depending on a variety of circumstances.<sup>134</sup> If the rule contained a specific distribution deadline, would these types of funds need a separate deadline or other special treatment?

- Instead of requiring prompt distribution of the audited financial statement to investors, should we require the statement to be distributed or made available to investors upon request?
- Should the rule provide additional flexibility, such as for situations in which the adviser can demonstrate that it reasonably believed that it would be able to comply with the rule but failed due to certain unforeseeable circumstances?
- Should the rule require annual audits, as proposed? Should the rule require an audit upon a private fund's liquidation, as proposed? Should we modify either or both of these requirements? If so, how should we modify these requirements, and why?
- Advisers would be required to comply with the proposed audit rule beginning with their first fiscal year after the compliance date and any liquidation that occurs after the compliance date. Advisers would also be required to obtain an audit annually. We understand that newly formed and liquidating funds may face unique challenges. For instance, the value provided by an audit of a very short period of time, such as a period of less than three-months (a "stub period"), may be diminished because there is a lack of comparability in the information provided. In addition, we understand that the cost of obtaining an audit covering a few months can be similar to the cost of an audit covering an entire fiscal year. We further understand that when newly formed entities have few financial transactions and/or investments, obtaining an audit, relative to the investor protections ultimately offered by obtaining the audit, may be burdensome. Should the rule allow newly formed or liquidating entities to obtain an audit less frequently than annually to avoid stub period audits? Should the rule permit advisers to satisfy the audit requirement by relying on an audit on an interval other than annually when a fund is liquidating? For example, should we allow advisers

<sup>134</sup> See generally Staff Responses to Questions About the Custody Rule, available at [https://www.sec.gov/divisions/investment/custody\\_faqs\\_030510.htm](https://www.sec.gov/divisions/investment/custody_faqs_030510.htm).

to rely on an audit of a fund every two years during the liquidation process?

- If the rule were to permit audits less frequently than on an annual basis, should it also include additional restrictions or requirements? If so, what restrictions or requirements, and why? For instance, should it require investment advisers to create and distribute alternative financial reporting for the fund to investors (*e.g.*, cash-flow audit or asset verification)? Alternatively, or in addition to alternative financial reporting, should the rule require advisers to obtain a third-party examination? If so, what should the examination consist of, and why? For example, would allowing advisers to obtain an audit less frequently than annually during a liquidation raise investor protection concerns that additional requirements could address given the potential for a liquidation to last for an extended period? If so, what additional requirements, and why? For example, should advisers be required to provide notice to investors of their intent to liquidate an entity in these circumstances? Should advisers be required to obtain investor consent prior to satisfying the audit requirement by relying on audits on a less than annual basis? Should we set an outer limit for the period such an audit could cover (*e.g.*, 15 months)?

- Should the rule define “liquidation” for purposes of the liquidation audit requirement? If so, how? For example, should we base such a definition on a certain percentage of assets under management of the entity from or over previous fiscal period(s) or a stated threshold based on an absolute dollar amount of the entity’s assets under management? Should we base the definition on a calculation of the ratio of the management fees assessed on assets under management of the entity or some other basis, for example, to detect whether an adviser is charging management fees on a very small amount of assets?

- Are there risks posed to investors when an entity is liquidating that the proposed rule does not address? If so, please describe those risks. How should we modify the rule to address such risks?

- Are there some types of investments that pose a greater risk of misappropriation or loss to investors during a liquidation that the rule should specifically address to provide greater investor protection? If so, please describe the investment type; the particular risk the investment type poses to investors during liquidation;

and how to modify the proposed rule to address such investor risk.

- We are not proposing the filing of a copy of the audit report or a copy of the audited financial statements with the Commission; should the rule contain such a requirement? Why or why not?

- Would the requirement for an accountant to comply with the notification requirement change the approach that an accountant would take with respect to audits that normally are performed for purposes of satisfying the custody rule? If so, how?

- Should we, as proposed, require advisers to enter into, or cause a private fund to enter into, a written agreement with the independent public accountant completing the audit to notify the Commission in connection with a modified opinion or termination?

- Do commenters agree that the professional engagement period of an audit performed under the rule should begin and end as indicated in Regulation S–X rule 2–01(f)(5), as proposed? If not, why not?

- As noted above, the proposed Commission notification provision bears some similarities to, and is drawn from our experience with, a similar custody rule requirement in the surprise examination context with which we believe advisers may likely already have some familiarity. The regulations in 17 CFR 240.17a–5 (rule 17a–5) require a broker or dealer’s self-report to the Commission within one business day and to provide a copy to the accountant. The accountant must report to the Commission about any aspects of the broker or dealer’s report with which the accountant does not agree. If the broker or dealer fails to self-report, the accountant must report to the Commission to describe any material weaknesses or any instances of non-compliance that triggered the notification requirement. Should the audit rule contain similar requirements? Why or why not? Are private fund advisers and the accountants that perform private fund financial statement audits more familiar with Rule 17a–5’s notification requirement than the custody rule’s notification requirement?

- Do commenters agree that the related proposed amendments to the books and records rule would facilitate compliance with the proposed audit rule? What additional or alternative amendments should the rule include, if any?

### C. Adviser-Led Secondaries

We propose to require an adviser to obtain a fairness opinion in connection with certain adviser-led secondary

transactions where an adviser offers fund investors the option to sell their interests in the private fund, or to exchange them for new interests in another vehicle advised by the adviser. This would provide an important check against an adviser’s conflicts of interest in structuring and leading a transaction from which it may stand to profit at the expense of private fund investors. The proposed adviser-led secondaries rule would prohibit an adviser from completing an adviser-led secondary transaction with respect to any private fund, unless the adviser distributes to investors in the private fund, prior to the closing of the transaction, a fairness opinion from an independent opinion provider and a summary of any material business relationships the adviser or any of its related persons has, or has had within the past two years, with the independent opinion provider.<sup>135</sup>

Investments in closed-end private funds are typically illiquid and require a long-term investor commitment of capital. Such funds generally do not permit investors to withdraw or redeem their fund interests prior to the end of the term. Open-end private funds may also limit or restrict an investor’s ability to withdraw or redeem its interest, for example, with side pockets or illiquid sleeves. Without the ability to cash out all or a portion of their interest from the fund, investors have historically sought liquidity by selling their interests on the secondary market to third parties. Advisers typically have a relatively minor role in such “investor-led” transactions, as investors engage in the transaction directly with the prospective purchaser.

In recent years, advisers have become increasingly active in the secondary market. The number of “adviser-led” transactions has increased, with the deal value of such transactions representing a meaningful portion of the secondary market, particularly for closed-end private funds.<sup>136</sup> Adviser-led transactions are similar to investor-led transactions in that they typically provide a mechanism for investors to obtain liquidity; however, they also

<sup>135</sup> Proposed rule 211(h)(2)–2. The proposed rule would not apply to advisers that are not required to register as investment advisers with the Commission, such as state-registered advisers and exempt reporting advisers.

<sup>136</sup> See, *e.g.*, Private Equity International, GP-Led Secondaries Report (Feb. 28, 2021), available at <https://www.privateequityinternational.com/gp-led-secondaries-report-2021/> (noting one industry participant estimated that adviser-led secondary transactions accounted for \$26 billion (or 44% of the secondary market) in 2020, while another estimated that they accounted for more than \$30 billion (or more than 50% of the secondary market)).

have the potential to provide additional benefits to advisers and investors. For example, an adviser-led transaction may seek to secure additional capital and/or time to maximize the value of fund assets. An adviser may accomplish this by permitting investors to “roll” their interests into a new vehicle that has a longer term and/or additional capital to invest.<sup>137</sup>

Adviser-led secondaries often are highly bespoke transactions that can take many forms. For purposes of the rule, we propose to define them as transactions initiated by the investment adviser or any of its related persons that offer the private fund’s investors the choice to: (i) Sell all or a portion of their interests in the private fund; or (ii) convert or exchange all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons.<sup>138</sup> We generally would consider a transaction to be initiated by the adviser if the adviser commences a process, or causes one or more other persons to commence a process, that is designed to offer private fund investors the option to obtain liquidity for their private fund interests. However, whether the adviser or its related person initiates a secondary transaction requires a facts and circumstances analysis. We would generally not view a transaction as initiated by the adviser if the adviser, at the unsolicited request of the investor, assists in the secondary sale of such investor’s fund interest.

This definition generally would include secondary transactions where a fund is selling one or more assets to another vehicle managed by the adviser, if investors have the option either to obtain liquidity or to roll all or a portion of their interests into the other vehicle. Examples of such transactions may include single asset transactions (such as the fund selling a single asset to a new vehicle managed by the adviser), strip sale transactions (such as the fund selling a portion of multiple assets to a new vehicle managed by the adviser), and full fund restructurings (such as the fund selling all of its assets to a new vehicle managed by the adviser). The proposed definition also would capture secondary transactions that may not involve a cross sale between two vehicles managed by the same adviser.<sup>139</sup> For example, an adviser may

arrange for one or more new investors to purchase fund interests directly from the existing investors as part of a “tender offer” or similar transaction.

While adviser-led transactions can provide liquidity for investors and secure additional time and capital to maximize the value of fund assets, they also raise certain conflicts of interest. The adviser and its related persons typically are involved on both sides of the transaction and have interests in the transaction that are different than, or in addition to, the interests of the private fund investors. For example, because the adviser may have the opportunity to earn economic and other benefits conditioned upon the closing of the secondary transaction, such as additional management fees or carried interest, the adviser generally has a conflict of interest in setting and negotiating the transaction terms.

Ensuring that the private fund and the investors that participate in the secondary transaction are offered a fair price is a critical component of preventing the type of harm that might result from the adviser’s conflict of interest in leading the transaction.<sup>140</sup> Accordingly, prior to the closing of the transaction, the proposed rule would require advisers to obtain a written opinion stating that the price being offered to the private fund for any assets being sold as part of an adviser-led secondary transaction is fair.<sup>141</sup> This process would provide an important market check for private fund investors by providing some assurance that the price being offered is based on an underlying valuation that falls within a range of reasonableness. We understand that certain advisers obtain fairness opinions as a matter of best practice because investors often lack access to sufficient information, or may not have the capabilities or resources, to conduct their own analysis of the price. However, to the extent that this practice is not universal, the proposed rule would mandate it in connection with all adviser-led secondary transactions.

To mitigate the potential influence of the adviser’s conflict of interest further, the rule would require these opinions to be issued only by an “independent

opinion provider,” which is one that (i) provides fairness opinions in the ordinary course of its business and (ii) is not a related person of the adviser.<sup>142</sup> The ordinary course of business requirement would largely correspond to persons with the expertise to value illiquid and esoteric assets based on relevant criteria. The requirement that the opinion provider not be a related person of the adviser would reduce the risk that certain affiliations could result in a biased opinion.<sup>143</sup>

We recognize, however, that other business relationships may have the potential to result, or appear to result, in a biased opinion, particularly if such relationships are not disclosed to private fund investors. For example, an opinion provider that receives an income stream from an adviser for performing services unrelated to the issuance of the opinion might not want to jeopardize its business relationship with the adviser by alerting the private fund investors that the price being offered is unfair (or by otherwise refusing to issue the fairness opinion). By requiring disclosure of such material relationships, the proposed rule would put private fund investors in a position to evaluate whether any conflicts associated with such relationships may cause the opinion provider to deliver a biased opinion. Thus, the proposed rule would require the adviser to prepare and distribute to private fund investors a summary of any material business relationships the adviser or any of its related persons has, or has had within the past two years, with the independent opinion provider. Whether a business relationship would be material under the proposed rule would require a facts and circumstances analysis; however, for purposes of the proposed rule, we believe that audit, consulting, capital raising, investment banking, and other similar services would typically meet this standard.

The proposed rule would require an adviser to distribute the opinion and the material business relationship summary to investors.<sup>144</sup> We believe that this proposed requirement would ensure that investors receive the benefit of an independent price assessment, which we believe will improve their decision-making ability and their overall confidence in the transaction.

We request comment on all aspects of the proposed rule, including the following items:

<sup>137</sup> An investor would typically obtain liquidity in the event it elects to sell—rather than roll—its fund interest.

<sup>138</sup> Proposed rule 211(h)(1)–1.

<sup>139</sup> We would not consider the proposed rule to apply to cross sales where the adviser does not offer the private fund’s investors the choice to sell, convert, or exchange their fund interest.

<sup>140</sup> As a fiduciary, the adviser is obligated to act in the fund’s best interest and to make full and fair disclosure to the fund of all conflicts and material facts associated with the adviser-led transaction. See, e.g., *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Investment Advisers Act Release No. 5248 (June 5, 2019) [84 FR 33669 (July 12, 2019)], at 24–25 (“2019 IA Fiduciary Duty Interpretation”). See also EXAMS Private Funds Risk Alert 2020, *supra* footnote 9.

<sup>141</sup> Proposed rule 211(h)(1)–1 (defining “fairness opinion”).

<sup>142</sup> Proposed rule 211(h)(1)–1.

<sup>143</sup> See *supra* section II.A for a discussion of the definition of “related person.”

<sup>144</sup> Proposed rule 211(h)(2)–2.

- Do commenters agree that adviser-led secondary transactions can be of some benefit to a private fund and its investors?

- Do commenters agree with the scope of the proposed rule? Should the rule apply to all investment advisers? Why or why not? What are the factors that weigh in favor of expanding the scope of the proposed rule to apply to a broader scope of advisers than proposed? Are there particular types of advisers that should or should not be subject to the rule? Should the rule only apply when the adviser or its related person is general partner (or equivalent) of a fund that is party to the transaction?

- Should certain adviser-led transactions be exempt from the proposed rule? For example, if the adviser conducts a competitive sale process for the assets being sold, which ultimately leads to the price, should advisers still be required to obtain a fairness opinion? Do competitive bids typically represent net asset value? Do prospective purchasers typically bid at a discount to net asset value? Does net asset value always correspond to the current value of the assets being sold? Why or why not? Are there other price discovery processes that we should require to protect investors?

- Should certain adviser-led transactions be exempt from the rule, such as adviser-led transactions involving liquid funds? For example, if the underlying assets being sold in the transaction are predominantly publicly traded securities, should advisers still be required to obtain a fairness opinion? Do such transactions present the same concerns as adviser-led secondary transactions involving illiquid funds where the underlying assets are typically illiquid and not listed or quoted on a securities exchange? Are there other hedge fund transactions that we should exempt from the rule, such as hedge fund restructurings where an adviser may be merging the portfolios of two different hedge funds and gives all affected investors the option to redeem or convert/exchange their interests into the new fund? Should the exemption depend on whether the price of the transaction is based on net asset value? Why or why not?

- Are there other transactions for which we should require private fund advisers to obtain a fairness opinion? For example, should we require advisers to obtain a fairness opinion before certain cross transactions between private funds it manages? If so, which transactions? Should we provide certain cross transaction exemptions, such as exemptions for bridge financings or syndications where the selling fund

transfers the investments within a short period at a price equal to cost plus interest?

- Should the scope of the fairness opinion be limited to the price, as proposed? Alternatively, should we require the fairness opinion to cover all, or certain other, terms of the transaction? For example, should we revise the definition of “fairness opinion” to a written opinion stating that the terms of the adviser-led secondary transaction are fair to the private fund? Why or why not?

- Should the rule give investment advisers the option to obtain either a fairness opinion or a third-party valuation? Why or why not? What are the advantages and disadvantages of a third-party valuation as compared to a fairness opinion, and *vice versa*?

- We request comment on the proposed use of “related person.” Do commenters agree that the fairness opinion should be issued by a person that is not a related person of the adviser? Should we adopt a different definition of “related person” than the one proposed?

- The proposed rule would require an “independent opinion provider” to provide fairness opinions “in the ordinary course of its business.” Do commenters agree with this approach?

- Instead of requiring disclosure of any material business relationships between the adviser (or its related persons) and the independent opinion provider, should the rule prohibit firms with certain business relationships with the adviser, its related persons, or the private fund from providing the fairness opinion? For example, if a firm has provided consulting, prime broker, audit, capital raising, or investment banking services to the private fund or the adviser or its related persons within a certain time period—such as two or three years—should the rule prohibit the firm from providing the opinion? If so, should the rule include a threshold of materiality, regularity, or frequency for some or all of such services to trigger such a prohibition?

- Should we require the independent opinion provider to have any specific qualifications, licenses, or registrations?

- Should we define the term “transaction” in the definition of “adviser-led secondary transaction”? If so, how should the rule define “transaction”? Should we reference the various types of adviser-led secondary transactions in the definition? For example, should “transaction” include only single asset transactions, strip sale transactions, and other similar secondary transactions? Should we include in the definition of “adviser-led

secondary transaction” transactions initiated by the adviser’s related persons?

- Should we define, or provide additional guidance regarding, the phrase “initiated by the investment adviser or any of its related persons”? Should we define, or provide additional guidance regarding, the role the adviser would have to play in a secondary transaction for it to be considered an adviser-led transaction subject to the proposed rule?

- Should the rule require the fairness opinion to state that the private fund and/or its investors may rely on the opinion? Why or why not?

- Should we require the fairness opinion to be obtained on behalf of the private fund as proposed? Alternatively, should we require the fairness opinion to be obtained on behalf of the private fund investors? Are there characteristics of certain types of adviser-led transactions, such as tender offers, that would require the fairness opinion to be obtained on behalf of the private fund investors rather than the private fund?

- Should the adviser be required to distribute a summary of any material business relationships the adviser or its related persons has, or has had within the past two years, with the independent opinion provider as proposed? Should we provide guidance or impose requirements regarding the level of detail advisers should include in the summary? For example, should we require advisers to disclose the total amount paid to the independent opinion provider by the adviser or its related persons, if applicable? Why or why not? Is two years the appropriate look-back period? Are there any other conflict disclosures we should require in the fairness opinion or otherwise require to be made available to investors?

- Should we define “material business relationship” for purposes of the proposed rule? Should the rule include a threshold of regularity or frequency (in addition to or in lieu of the materiality threshold) for some or all of such relationships or services to trigger a disclosure requirement?

- Should we require advisers to distribute the fairness opinion to investors as proposed? Alternatively, should we require advisers to only distribute or make the fairness opinion available to investors upon request?

- We recognize that certain adviser-led transactions may not involve investors rolling their interests into a new vehicle managed by the adviser. For example, an adviser may arrange for a new investor to offer to purchase fund interests directly from existing

investors, such as a tender offer. Do commenters agree that the first prong of the definition would cover such transactions? Should the rule treat such transactions differently?

- Should the rule apply to adviser-led transactions initiated by the adviser or its related persons as proposed? Is the definition of “related person” too broad in this context such that it would capture secondary transactions initiated by third parties unrelated to the adviser? Should we revise the definition of “related person” to include an investment discretion requirement? Similarly, is the definition of “control” too broad in this context?

- We recognize that, for certain adviser-led transactions, the closing of the underlying deal may not occur simultaneously with the closing of the new vehicle managed by the adviser. How should the rule take this into account, if at all? For example, should we clarify that, for purposes of the rule, an adviser would not be deemed to have completed an adviser-led secondary transaction until the underlying deal has closed (if applicable)? Alternatively, should we prohibit an adviser from calling investor capital prior to obtaining and distributing the fairness opinion?

#### 1. Recordkeeping for Adviser-Led Secondaries

We propose amending rule 204–2 under the Advisers Act to require advisers to retain books and records to support their compliance with the proposed adviser-led secondaries rule, which would help facilitate the Commission’s inspection and enforcement capabilities. We propose to require advisers to retain a copy of the fairness opinion and material business relationship summary distributed to investors, as well as a record of each addressee, the date(s) the opinion was sent, address(es), and delivery method(s).<sup>145</sup> These proposed requirements would facilitate our staff’s ability to assess an adviser’s compliance with the proposed rule and would similarly enhance an adviser’s compliance efforts.

We request comment on this aspect of the proposed rule:

- Should we require advisers to maintain the proposed records or would these requirements be overly burdensome for advisers? Are there alternative or additional recordkeeping requirements we should impose?

- Should we require advisers to retain a record of each addressee, the date(s) the statement was sent, address(es), and delivery method(s) as proposed? Why or why not?

#### D. Prohibited Activities

We are also proposing to prohibit a private fund adviser from engaging in certain sales practices, conflicts of interest, and compensation schemes that are contrary to the public interest and the protection of investors. We have observed certain industry practices over the past decade that have persisted despite our enforcement actions and that disclosure alone will not adequately address.<sup>146</sup> As discussed below, we believe that these sales practices, conflicts of interest, and compensation schemes must be prohibited in order to prevent certain activities that could result in fraud and investor harm.<sup>147</sup> We believe these activities incentivize advisers to place their interests ahead of their clients’ (and, by extension, their investors’), and can result in private funds and their investors, particularly smaller investors that are not able to negotiate preferential deals with the adviser and its related persons, bearing an unfair proportion of fees and expenses. The proposed rule would prohibit these activities regardless of whether the private fund’s governing documents permit such activities or the adviser otherwise discloses the practices and regardless of whether the private fund investors (or governance mechanisms acting on their behalf, such as limited partner advisory committees) have consented to the activities either expressly or implicitly. Also, the proposed rule would prohibit these activities even if they are performed indirectly, for example by an adviser’s related persons, because the activities have an equal potential to harm the fund and its investors regardless of whether the adviser engages in the activity directly or indirectly.<sup>148</sup> As noted above, we believe these prohibitions are necessary given the lack of governance mechanisms that would help check overreaching by private fund advisers.

<sup>146</sup> See High-End Bargaining Problems, Vanderbilt Law Review (forthcoming), Professor William Clayton (Jan. 8, 2022) at 9 (challenging “the idea that sophisticated parties will demand appropriate levels of disclosure and appropriate processes without any intervention by policymakers . . .”).

<sup>147</sup> See sections 206 and 211(h)(2) of the Act.

<sup>148</sup> Any attempt to avoid any of the proposed rules’ restrictions, depending on the facts and circumstances, would violate section 208(d) of the Act’s general prohibitions against doing anything indirectly which would be prohibited if done directly. Section 208(d) of the Advisers Act.

Proposed rule 211(h)(2)–1 would prohibit an investment adviser to a private fund, directly or indirectly, from engaging in certain activities with respect to the private fund or any investor in that private fund, including:

- (i) Charging certain fees and expenses to a private fund or portfolio investment, including accelerated monitoring fees; fees or expenses associated with an examination or investigation of the adviser or its related persons by governmental or regulatory authorities; regulatory or compliance expenses or fees of the adviser or its related persons; or fees and expenses related to a portfolio investment on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment;

- (ii) Reducing the amount of any adviser clawback by the amount of certain taxes;

- (iii) Seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund; and

- (iv) Borrowing money, securities, or other fund assets, or receiving an extension of credit, from a private fund client.

This proposed rule would apply to all advisers to private funds, regardless of whether they are registered with the Commission or one or more states, exempt reporting advisers, or prohibited from registration. We believe that this scope is appropriate since we believe these activities are contrary to the public interest and the protection of investors and have the potential to lead to fraud. We are proposing this rule under sections 206 and 211 of the Advisers Act, which sections apply to all investment advisers, regardless of SEC-registration status.

We request comment on the scope of the proposed rule, including the following items:

- Should the rule apply to all advisers as proposed? Alternatively, should the rule apply only to SEC-registered advisers? If so, why?

- Should the rule only prohibit these activities with respect to an adviser’s private fund clients and the investors in those private funds? Should the rule apply more broadly or more narrowly? For example, should the rule apply to such activities with respect to *all* clients of an adviser? Should the rule apply to such activities with respect to persons to which the adviser offers co-

<sup>145</sup> See *supra* footnote 106 (describing the record retention requirements under the books and records rule).

investment opportunities even if the adviser does not classify them as its clients?

- We have historically taken the position that most of the substantive provisions of the Advisers Act do not apply with respect to the non-U.S. clients (including funds) of a registered offshore adviser.<sup>149</sup> In taking this approach, the Commission noted that U.S. investors in an offshore fund generally would not expect the full protection of the U.S. securities laws and that U.S. investors may be precluded from an opportunity to invest in an offshore fund if their participation would result in full application of the Advisers Act and rules thereunder.<sup>150</sup> Similarly, the proposed prohibited activities rule would not apply to a registered offshore adviser's private funds organized outside of the United States, regardless of whether the private funds have U.S. investors. Do commenters agree that registered offshore advisers should not be subject to this rule with respect to their offshore private fund clients or offshore investors? Should other rules in this rulemaking package take the same approach, or a different approach, with respect to a registered offshore adviser's offshore private fund clients? Please explain.

- Instead of prohibiting these activities, should the rule prohibit these activities unless the adviser satisfies certain governance and other conditions (e.g., disclosure to investors in all relevant funds/vehicles, approval by the limited partner advisory committee (or other similar body) or directors)? Should the rule prohibit these activities unless the adviser obtains approval for them by a majority (by number and/or in interest) of investors? Should the rule permit non pro-rata fee and expense allocations if such practice is disclosed to, and consented by, co-investors?

- Should we amend the books and records rule to require advisers to retain specific documentation evidencing compliance with the prohibited activities rule? For example, records showing how fees and expenses associated with an examination or investigation of the adviser or its related persons by governmental or regulatory authorities were paid or showing the

allocations of fees and expenses related to a portfolio investment on an investment by investment basis? Would advisers be able to obtain or generate sufficient records to demonstrate compliance with all aspects of the proposed rule? Should we amend the books and records rule to require advisers to prepare a memorandum on an annual basis attesting to their compliance with each aspect of the proposed rule?

#### 1. Fees for Unperformed Services

First, the prohibited activities rule would prohibit an investment adviser from charging a portfolio investment for monitoring, servicing, consulting, or other fees in respect of any services the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment.<sup>151</sup> These payments sometimes are referred to as "accelerated payments."

An adviser typically receives management fees and performance-based compensation for providing advisory services to a fund. A fund's portfolio investments may also make payments to the adviser and its related persons. For example, some private fund advisers enter into arrangements with a fund's portfolio investments to provide management, consulting, financial, servicing, advisory, or other services. The adviser and the applicable portfolio investment would enter into a monitoring agreement or a management services agreement documenting the payment terms and the services the adviser will provide.<sup>152</sup> Such agreements often include acceleration clauses, which permit the adviser to accelerate the unpaid portion of the fee upon the occurrence of certain triggering events, even though the adviser will never provide the contracted for services.<sup>153</sup> The accelerated payments reduce the value of the portfolio investment upon the private fund's exit and thus reduce returns to investors.

Because the private fund (and, by extension, its investors) typically bears the costs of such payments indirectly and the adviser typically receives the benefit, the receipt of such fees gives rise to conflicts of interest between the fund (and, by extension, its investors), on the one hand, and the adviser, on the

other hand. For example, the adviser receives the benefit of the accelerated fees without incurring any costs associated with having to provide any services. The private fund, however, may have a lower return on its investment because the accelerated monitoring fees may reduce the portfolio investment's available cash, in turn reducing the investment's value in advance of a public offering or sale transaction. An adviser also may have an incentive to cause the fund to exit a portfolio investment earlier than anticipated, which may result in the fund receiving a lesser return on its investment.<sup>154</sup> Further, the potential for the adviser to receive these economic benefits creates an incentive for the adviser to seek portfolio investments for its own benefit rather than for the fund's. We believe prohibiting this practice, which distorts the economic relationship between the private fund and the adviser, would help prevent the adviser from placing its own interests ahead of the private fund.

In addition to these conflicts, we believe that charging a portfolio investment for unperformed services creates a compensation scheme that is contrary to the public interest and the protection of investors because such practice unjustly enriches the adviser at the expense of the private fund and its underlying investors who are not receiving the benefit of any services. Accordingly, the proposed rule would prohibit an adviser from charging these types of accelerated payments.

The prohibited activities rule would not prohibit an adviser from receiving payment for services actually provided. The proposed rule also would not prohibit an adviser from receiving payments in advance for services that it reasonably expects to provide to the portfolio investment in the future. For example, if an adviser expects to provide monitoring services to a portfolio investment, the proposed rule would not prohibit the adviser from charging for those services.<sup>155</sup> Rather, the proposed rule would prohibit compensation schemes where an

<sup>154</sup> Such incentive may be mitigated, in certain circumstances, to the extent the adviser's performance-based compensation would also be reduced in whole or part by the receipt of these payments.

<sup>155</sup> To the extent the adviser ultimately does not provide the services, however, the proposed rule would require the adviser to refund any prepaid amounts attributable to the unperformed services. See proposed rule 211(h)(2)–1(a)(1) (prohibiting an adviser from charging a portfolio investment for fees in respect of any services that the investment adviser does not provide to the portfolio investment).

<sup>149</sup> See, e.g., *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers*, Investment Advisers Act Release No. 3222 (June 22, 2011) [76 FR 39645 (July 6, 2011)]; Marketing Release, *supra* footnote 61, at n.199.

<sup>150</sup> See *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Investment Advisers Act Release No. 2333 (Dec. 2, 2004) [69 FR 72054, 72072 (Dec. 10, 2004)].

<sup>151</sup> Proposed rule 211(h)(2)–1(a)(1).

<sup>152</sup> Monitoring fees frequently are based on a percentage of EBITDA (earnings before income, taxes, depreciation, and amortization). The agreements often renew automatically and typically include periodic fee increases.

<sup>153</sup> Common triggering events include initial public offerings, dispositions, and change of control events.



adviser charges for services that it does not reasonably expect to provide.

We also do not intend to prohibit an arrangement where the adviser shifts 100% of the economic benefit of any portfolio investment fee to the private fund investors, whether through an offset, rebate, or otherwise. We recognize that certain advisers offset management fees or other amounts payable to the adviser at the fund level by the amount of portfolio investment fees paid to the adviser. However, private funds with a 100% management fee offset would not comply with the proposed rule if there are excess fees retained by the adviser where no further management fee offset can be applied and the private fund investors are not offered a rebate or another economic benefit equal to their pro rata share of any such excess fees.

We request comment on this aspect of the prohibited activities rule, including the following items:

- Are there any scenarios in which we should permit an adviser to charge a fund's portfolio investment for unperformed services? If so, please explain.

- Should we prohibit an adviser from being paid in advance for services it reasonably expects to provide in the future? Why or why not?

- As noted above, if an adviser is paid in advance, and reasonably expects to perform services, but ultimately does not provide the contracted for services, the proposed rule would require the adviser to refund the prepaid amount attributable to the unperformed services. Do commenters agree with this approach? Why or why not?

- The proposed rule specifically references "monitoring, servicing, consulting, or other fees." Do commenters agree with this list? Should we eliminate any? Are there additional or alternative types of remuneration that the rule should reference?

- Do commenters agree that if an adviser shifts 100% of the economic benefit of any portfolio investment fee to the private fund investors, whether through an offset, rebate, or otherwise, the adviser would not violate the proposed rule? Why or why not? We recognize that certain tax-sensitive investors often waive the right to receive their share of any rebates of portfolio investment fees. How should the rule take into account such waivers, if it all? For example, to the extent one investor does not accept its share, should the rule require the adviser to distribute such amount to the other investors in the fund? Why or why not?

- Should the rule instead permit an adviser to engage in this activity if the

adviser satisfies certain disclosure, governance, and/or other conditions (e.g., disclosure to investors in all relevant funds/vehicles, approval by the LPAC (or other similar body) or directors)?

- The proposed rule would prohibit compensation schemes where an adviser charges for services that it does not *reasonably expect* to provide. Is "reasonably expect" the appropriate standard? Should we provide examples or guidance to assist advisers in complying with this standard? Does this standard have the potential to reduce the effectiveness of the rule? Are there other standards we should adopt?

## 2. Certain Fees and Expenses

The second and third elements of the prohibited activities rule would prevent an adviser from charging a private fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority, as well as regulatory and compliance fees and expenses of the adviser or its related persons.<sup>156</sup>

Advisers incur various fees and expenses in connection with the establishment and ongoing operations of their advisory business. Establishment fees and expenses often relate to the structuring and organization of the adviser's business, including the adviser's registration with financial regulators, such as the Commission. Ongoing fees and expenses often relate to the adviser's overhead and administrative expenses, such as salary, rent, and office supplies. Ongoing expenses also may include those associated with an examination or investigation of the adviser or its related persons.

The proposed rule would prohibit an adviser from charging a private fund for (i) fees and expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority, and (ii) regulatory or compliance fees and expenses of the adviser or its related persons, even where such fees and expenses are otherwise disclosed. We have seen an increase in private fund advisers charging these expenses to private fund clients. These types of expenses, which are a cost of being an investment adviser, should not be passed on to private fund investors, whether as a separate expense (in

addition to a management fee) or as part of a pass-through expense model.<sup>157</sup> For example, we believe advisers should bear the compliance expenses related to their registration with the Commission, including fees and expenses related to preparing and filing all items and corresponding schedules in Form ADV. Similarly, we believe that an adviser should bear any expenses related to state licensing and registration requirements applicable to the adviser and its related persons, including expenses related to registration and licensure of advisory personnel who contact or solicit investments from state pension or similar plans.

We believe allocating these types of expenses to a private fund client is contrary to the public interest and is harmful to investors because they create an incentive for an adviser to place its own interests ahead of the private fund's interests and unfairly allocate expenses to the fund, even where fully disclosed. For example, in some circumstances, an adviser may charge a fund significant fees and expenses in connection with an investigation that may not be in the fund's best interest. Further, as discussed above, we believe the prohibited fees and expenses are related to forming and operating an advisory business and thus should be borne by the adviser and its owners rather than the private fund and its investors.

We do not anticipate this aspect of the proposed prohibited activities rule would cause a dramatic change in practice for most private fund advisers, other than for certain advisers that utilize a pass-through expense model as noted above. We recognize, however, that advisers often charge private funds for regulatory, compliance, and other similar fees and expenses directly related to the activities of the private fund. The proposed rule would not change this practice. For example, the proposed rule would not prohibit an adviser from charging a private fund for all the costs associated with a regulatory filing of the fund, such as Form D.<sup>158</sup> In addition, we acknowledge that it may not be clear whether certain fees and

<sup>157</sup> Certain private fund advisers utilize a pass-through expense model where the private fund pays for most, if not all, expenses, including the adviser's expenses, but the adviser does not charge a management, advisory, or similar fee. We recognize that this aspect of the proposed rule would likely require advisers that pass on the types of fees and expenses we propose to prohibit to re-structure their fee and expense model.

<sup>158</sup> Advisers may be liable under the antifraud provisions of the Federal securities laws if the private fund's offering and organizational documents do not authorize such costs to be charged to the private fund.

<sup>156</sup> Proposed rules 211(h)(2)–1(a)(2) and (3). This prohibition would include fees and expenses related to an examination or investigation of the adviser by the Commission, including the amount of any settlements or fines paid in connection therewith.

expenses relate to the fund or the adviser, or it may not be clear until after a significant amount of time has passed in certain cases. In these circumstances, an adviser generally should allocate such fees and expenses in a manner that it believes in good faith is fair and equitable and is consistent with its fiduciary duty.

We request comment on this aspect of the prohibited activities rule, including the following items:

- Are there circumstances in which it would be appropriate in the public interest or for the protection of investors for a private fund to bear (i) regulatory or compliance expenses of the adviser or its related persons or (ii) expenses related to an examination or investigation of the adviser or its related persons? If so, please explain. Should we permit private funds to bear these fees and expenses if fully disclosed and consented to by the private fund investors and/or an LPAC (despite the limitations of private fund governance mechanisms, as discussed above)? Should we place any conditions on charging these fees and expenses, such as caps, management fee offsets, or detailed reporting requirements in the proposed quarterly statement?

- The proposed rule would likely increase operating costs for advisers that have historically charged private funds for the types of fees and expenses covered by the proposed rules.

Do commenters believe that advisers would increase management fees to offset such increase in operating costs?

- Are there any additional types of fees or expenses that we should prohibit an adviser from charging to a private fund? Alternatively, are there fees and expenses that the rule should not prohibit?

- Should we provide exceptions to the proposed rules for certain types of private funds and/or certain types of advisers? For example, should we permit a first-time fund adviser to charge regulatory and compliance expenses to the fund? If so, why?

- Do commenters agree that many advisers do not currently charge private funds for the types of fees and expenses covered by the proposed rules and, as a result, the proposed rules would not cause a dramatic change in industry practice? Why or why not? To the extent commenters disagree, please provide supporting data.

- Will advisers have difficulty in determining whether fees and expenses relate to the adviser's activities versus the fund's activities? Should we provide guidance to assist advisers in making such a determination? If so, what guidance should we provide? Should

the rule list certain types of fees and expenses that relate to the adviser's activities versus the fund's activities?

- As discussed above, we recognize that certain private fund advisers utilize a pass-through expense model. Should the rule provide any full or partial exceptions for advisers utilizing such models, particularly where the adviser does not charge any management, advisory, or similar fees to the private fund?

### 3. Reducing Adviser Clawbacks for Taxes

The fourth element of the prohibited activities rule would prohibit an adviser from reducing the amount of any adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders. We propose to define "adviser clawback" as any obligation of the adviser, its related persons, or their respective owners or interest holders to restore or otherwise return performance-based compensation to the private fund pursuant to the private fund's governing agreements.<sup>159</sup> We propose to define "performance-based compensation" as allocations, payments, or distributions of capital based on the private fund's (or its portfolio investments') capital gains and/or capital appreciation.<sup>160</sup>

Investors typically seek to align their interests with the adviser's interest by tying the adviser's compensation to the success of the private fund. To accomplish this, many private funds provide the adviser with a disproportionate share of profits generated by the fund, often referred to as performance-based compensation.<sup>161</sup> The adviser's performance-based share of fund profits is often greater than the adviser's ownership percentage in the fund.<sup>162</sup> Although the percentage can vary, a common performance-based compensation percentage is 20%, meaning that, for each dollar of profit generated by the fund, the adviser is generally entitled to 20 cents and the

fund investors are generally entitled to the remaining 80 cents.

Because the profitability of a private fund will fluctuate over time, the amount of performance-based compensation to which the adviser is entitled will also fluctuate. For example, a fund may initially generate significant profits due to early realizations of successful investments, resulting in distributions to the adviser. However, the fund may subsequently dispose of unsuccessful investments, resulting in losses to the fund. Certain private funds include "clawback" mechanisms in their governing agreements, which require the adviser (or a related person of the adviser)<sup>163</sup> to restore distributions or allocations to the fund to the extent the adviser receives performance-based compensation in excess of the amount to which it is otherwise entitled under the fund's governing agreement. Typically, this means that the adviser is required to return to the fund distributions or allocations representing more than a specified percentage (*e.g.*, 20%) of the fund's aggregate profits. The clawback mechanism is intended to ensure that the adviser and the investors ultimately receive the appropriate split of cumulative profits generated over the life of the fund or the applicable measurement period.

Advisers and investors often negotiate whether the clawback amount should be reduced by taxes paid, or deemed paid, by the adviser or its owners.<sup>164</sup> For example, if an adviser received \$10 of "excess" performance-based compensation, but the adviser or its owners paid \$3 in taxes on such amount, investors often argue that the adviser should be required to return the "pre-tax" amount (\$10), while advisers argue that they should only be required to return the "post-tax" amount (\$7). To support the post-tax position, advisers often argue that they should only be required to return the portion of excess

<sup>163</sup> For tax and other reasons, a related person of the adviser, rather than the adviser, often receives the performance-based compensation from the fund.

<sup>164</sup> Fund agreements may require advisers to restore performance-based compensation under other fact patterns as well. For example, if an adviser has received performance-based compensation, but the investors have not received the requisite preferred return amount, the adviser may be subject to a clawback. Any such requirement to restore or otherwise return performance-based compensation under a private fund's governing agreement would be covered by the proposed rule. See proposed rule 211(h)(1)–1 (defining "adviser clawback" as any obligation of the adviser, its related persons, or their respective owners or interest holders to restore or otherwise return performance-based compensation to the private fund pursuant to the private fund's governing agreements).

<sup>159</sup> Proposed rule 211(h)(2)–1(a)(4). Because performance-based compensation may be allocated or granted to individuals and entities otherwise unaffiliated with the adviser, the proposed definition is drafted broadly to capture any owner or interest holder of the adviser or its related persons.

<sup>160</sup> Proposed rule 211(h)(1)–1. The proposed rule would not apply to any clawbacks by an adviser of incentive compensation under an arrangement subject to Section 956 of the Dodd-Frank Act and regulations thereunder.

<sup>161</sup> Certain private funds refer to performance-based compensation as carried interest, incentive fees, incentive allocations, or profit allocations.

<sup>162</sup> For alignment of interest purposes, advisers often invest their own capital in the fund alongside the third party capital.

distributions they ultimately retain (and not the portion paid to any taxing authority). Advisers also argue that, to the extent the clawback occurs in any year subsequent to the year in which the performance-based compensation was paid, it may be burdensome or impractical for the adviser or its owners to amend tax returns from prior years or otherwise take advantage of loss carryforwards for future tax years.<sup>165</sup>

We believe that reducing the amount of any adviser clawback by taxes applicable to the adviser puts the adviser's interests ahead of the investors' interests and creates a compensation scheme that is contrary to the public interest and the protection of investors, even where such practice is disclosed. The interests of investors to receive their share of fund profits—without any adviser tax reductions—justifies the burdens on advisers, including the obligation to amend tax returns. Advisers typically have control over the methodology used to determine the timing of performance-based compensation distributions or allocations, such as any waterfall arrangement.<sup>166</sup> Advisers also typically have control over whether the fund will make a distribution or allocation of performance-based compensation. Advisers thus have discretion to defer or otherwise delay payments, particularly if the adviser is concerned about the possibility of a clawback.<sup>167</sup> Even if an adviser cannot defer or delay a payment, the adviser can escrow performance-

based compensation rather than making a payment to its owners, which would allow the adviser to cover all or a portion of a clawback obligation that may arise in the future. Accordingly, the proposed rule would foster greater alignment of interest between advisers and investors by prohibiting advisers from unfairly causing investors to bear these tax costs associated with the payment, distribution, or allocation of “excess” performance-based compensation.

We request comment on this aspect of the proposed rule, including the following items:

- Would this aspect of the proposed prohibited activities rule have our intended effect of ensuring that investors receive their full share of profits generated by the fund? Is there an alternative approach that would better produce this intended effect? For example, should we require advisers to return the entire amount of any adviser clawback, rather than only prohibiting advisers from reducing the clawback amount by actual, potential, or hypothetical taxes? Would this approach ensure that investors receive their full share of fund profits?

- Would the proposed clawback provision result in more whole-fund waterfalls (commonly referred to as European waterfalls in the private funds industry), which generally delay payments of performance-based compensation until investors receive a return of all capital contributions? What other effects would this aspect of the proposed rule have on the industry, including with respect to adviser's ability to attract, retain, and develop investment professionals?

- Instead of the proposed clawback provision, should we prohibit deal-by-deal waterfall arrangements (commonly referred to as American waterfalls)?

- We recognize that clawback mechanisms are more common for closed-end funds and less common for open-end funds. Should the rule separately address performance-based compensation for open-end private funds? If so, how should we address those funds?

- Is the proposed definition of “adviser clawback” clear? Are there ways in which the proposed definition is over- or under-inclusive? For example, should the definition include “all-partner” givebacks or clawbacks (*i.e.*, should advisers be prohibited from reducing the portion of an all-partner giveback attributable to their

performance-based compensation by taxes paid or deemed paid)?<sup>168</sup>

- Is the proposed definition of “performance-based compensation” clear? Is it too narrow or too broad?

- What issues may advisers face in complying with this aspect of the proposed prohibited activities rule? In particular, what issues may result with respect to amending tax returns from prior years?

- We recognize that this aspect of the proposed rule might result in delayed payments of performance-based compensation. For example, during the early stages of the fund, the adviser may be less inclined to distribute performance-based compensation to investment professionals that source or manage successful investments. How would this aspect of the proposed prohibited activities rule affect the intended incentive effects of performance-based compensation?

- We recognize that many fund agreements clawback performance-based compensation on a post-tax basis. We considered, but are not proposing, a rule that would generally allow this practice to continue, but would prohibit advisers from using a hypothetical marginal tax rate to determine the tax reduction amount.<sup>169</sup> We considered requiring advisers to use the actual marginal tax rates applicable to the adviser or its owners, rather than a hypothetical marginal tax rate. Our view is that this approach could be too burdensome for advisers. Do commenters agree? If we were to adopt this approach, how should we factor tax benefits realized by the adviser or its owners into the tax reduction amount? What operational challenges would advisers face under this alternative approach? For example, would the amount of time it may take to determine

<sup>165</sup> When the clawback occurs in a subsequent tax year, the “excess” performance-based compensation will likely have already been subject to tax in the year it was paid, even if the amount subject to the clawback is determined on a pre-tax basis.

<sup>166</sup> Private fund investors often seek to negotiate the waterfall arrangement, and the timing of performance-based compensation distributions, with the adviser. The issues relating to clawbacks often arise in the context of a waterfall arrangement that provides performance-based compensation to the adviser on a deal-by-deal basis (or modified versions thereof), versus a waterfall arrangement that is applied across the whole-fund with distributions going to investors until the investors recoup 100% of their capital contributions and receive a preferred return thereon. Both models should generally result in the adviser and the investors receiving the same split of fund profits over the life of the fund assuming the fund documents have a clawback mechanism. The main distinction between the two models is the timing of distributions or allocations of performance-based compensation to the adviser. Whole-fund waterfalls are often referred to in the private funds industry as European waterfalls; deal-by-deal waterfalls are often referred to as American waterfalls.

<sup>167</sup> We recognize that an adviser (and its personnel) may be subject to a tax obligation whether or not the fund makes a distribution, payment, or allocation of performance-based compensation (*e.g.*, tax allocations of income may precede or follow cash payments of performance-based compensation), including if the adviser places the performance-based compensation into escrow.

<sup>168</sup> An “all-partner” giveback is typically a requirement for all investors to return or otherwise restore distributions to the fund. An adviser may use this mechanism for the purpose of satisfying fund obligations, liabilities, or expenses.

<sup>169</sup> Because many entities that receive performance-based compensation are fiscally transparent for U.S. Federal income tax purposes and thus not subject to entity-level taxes, determining the actual taxes paid on “excess” performance-based compensation can be challenging, particularly for larger advisers that have not only a significant number of participants that receive such compensation but also have participants subject to non-U.S. tax regimes. To address this problem, advisers typically use a “hypothetical marginal tax rate” to determine the tax reduction amount, which is usually based on the highest marginal U.S. Federal, state, and local tax rates. Advisers argue that this approach is a reasonable and cost-effective method for determining the tax reduction amount; investors argue that the hypothetical rate is too high and therefore reduces the clawback amount to their detriment.

the actual tax amount, which may not be determined until a significant amount of time has passed not justify the benefits? Do commenters believe that the use of a hypothetical marginal tax rate is a reasonable and cost-effective method for determining the tax reduction amount, or do commenters believe that the hypothetical marginal tax rate is too high? Why or why not? Please provide data.

#### 4. Limiting or Eliminating Liability for Adviser Misconduct

The fifth element of the proposed prohibited activities rule would prohibit an adviser to a private fund, directly or indirectly, from seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund.

Currently, many private funds and/or their investors enter into documents containing such contractual terms. Our staff has observed private fund agreements with waiver and indemnification provisions that have become more aggressive over time. For example, our staff recently encountered many limited partnership agreements that state that the adviser to the private fund or its related person, which is the general partner to the fund, to the maximum extent permitted by applicable law, will not be subject to any duties or standards (including fiduciary or similar duties or standards) existing under the Advisers Act, Delaware law, or Cayman Islands law or will not be liable to the fund or investors for breaching its duties (including fiduciary duties) or liabilities (that exist at law or in equity).<sup>170</sup>

While these contractual terms may be permissible under certain state laws, a waiver of an adviser's compliance with its Federal antifraud liability for breach of fiduciary duty to the private fund or with any other provision of the Advisers

Act or rules thereunder is invalid under the Act.<sup>171</sup> The prohibited activities rule would specify the types of contractual provisions that would be invalid.<sup>172</sup> For instance, it would prohibit an adviser from seeking indemnification for breaching its fiduciary duty, regardless of whether state or other law would permit an adviser to waive its fiduciary duty. The proposed rule would also prohibit an adviser from seeking reimbursement for its willful malfeasance. This scope of prohibitions is appropriate because these activities harm investors by placing the adviser's interests above those of its private fund clients (and investors in such clients). By limiting an adviser's responsibility for breaching the standard of conduct, the incentive to comply with the required standard of conduct is eroded. We believe such contractual provisions are neither in the public interest nor consistent with the protection of investors, particularly where investors are led to believe the adviser is contractually not obligated to comply with certain provisions of the Act or rules thereunder, or where investors with less bargaining power are forced to bear the brunt of such arrangements.<sup>173</sup>

We request comment on this aspect of the proposed rule, including the following items:

- We have observed these types of contractual provisions among private

<sup>171</sup> See section 215(a) of the Advisers Act; 2019 IA Fiduciary Duty Interpretation, *supra* footnote 140 (stating that an adviser's Federal fiduciary obligations are enforceable through section 206 of the Advisers Act and that the SEC would view a waiver of enforcement of section 206 as implicating section 215(a) of the Advisers Act. Section 215(a) of the Advisers Act provides that any condition, stipulation or provision binding any person to waive compliance with any provision of the title shall be void.).

<sup>172</sup> See section 215(b) of the Advisers Act (stating that any contract made in violation of the Act or rules thereunder is void).

<sup>173</sup> See Professor Clayton Article, *supra* footnote 7, at 309 (noting that "LPAs have been criticized for waiving and otherwise limiting managers' fiduciary duties to their investors under state limited partnership law; for seeking to satisfy managers' fiduciary duties under Federal law by providing generic and all-encompassing disclosures . . . for requiring investors to indemnify managers for liabilities resulting from an extremely broad array of conduct, including criminal acts committed by managers"). See also The Private Equity Negotiation Myth, Yale Journal on Regulation Vol. 37:67, Professor William Clayton (2020), at p. 70 (noting that "large investors in private equity funds commonly use their bargaining power to negotiate for individualized benefits outside of fund agreements, where the benefit of the bargain is not shared with other investors in the fund . . . an investor can use its bargaining power to negotiate for individualized benefits before it negotiates for things that will benefit all investors in the fund."); ILPA Model Limited Partnership Agreement (July 2020) (suggesting standard of care, exculpation, and indemnification language in order to reduce the cost, time and complexity of negotiating the terms of investment).

fund advisers and their related persons; do advisers to clients other than private funds typically include these types of contractual provisions?

- Are there other types of contractual provisions we should prohibit as contrary to the public interest and the protection of investors?

- Should this aspect of the final prohibited activities rule prohibit limiting liability for "gross negligence," or would prohibiting limitations of liability for ordinary negligence, as proposed, be more appropriate? Why?

- Should the proposed rule prohibit contractual provisions that limit or purport to waive fiduciary duties and other liabilities in situations where state law permits such waivers?

- Do commenters believe that the proposed rule would increase operating expenses for advisers? For example, would the proposed prohibition on receiving indemnification/exculpation for negligence cause an adviser's insurance premium to increase?

#### 5. Certain Non-Pro Rata Fee and Expense Allocations

The sixth element of the prohibited activities rule would prohibit an adviser from directly or indirectly charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment.<sup>174</sup>

An adviser may cause a private fund and one or more other vehicles to invest in an issuer or entity in which other related funds or vehicles have, or are concurrently making, an investment. For example, an adviser may form a parallel fund in a non-U.S. jurisdiction, such as Luxembourg, to accommodate certain European or other non-U.S. investors that invest alongside the adviser's main fund in all, or substantially all, of its investments. An adviser also may form more bespoke structures for large or strategic investors, such as separate accounts, funds of one, and co-investment vehicles, that invest alongside other funds managed by the adviser that have similar or overlapping investment strategies.

An adviser can face conflicts of interest where multiple clients (and/or other persons advised by the adviser) invest, or propose to invest, in the same portfolio investment, especially with respect to allocating fees and expenses among those clients (or such other

<sup>170</sup> See, e.g., EXAMS Private Funds Risk Alert 2022, *supra* footnote 16 (discussing hedge clauses). See also Comment Letter of the Institutional Limited Partners Association on the Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation (Aug. 6, 2018), File No. S7-09-18, at 6, available at <https://ilpa.org/wp-content/uploads/2018/08/ILPA-Comment-Letter-on-SEC-Proposed-Fiduciary-Duty-Interpretation-August-6-2018.pdf>. See also Protecting LLC Owners While Preserving LLC Flexibility, University of California, Davis Law Review, 51 U.C. Davis L. Rev. 2129, 2133, Professor Peter Molk (2018) (discussing scenarios in which an investor is induced to "sign away fundamental protections" without understanding the importance of those protections, without understanding the meaning of certain legal terms, and sometimes without reading the documents the investor signs).

<sup>174</sup> Proposed rule 211(h)(2)-1(a)(6).

persons).<sup>175</sup> We believe that any non-pro rata allocation of fees and expenses under these circumstances is contrary to the protection of investors because it would result in the adviser placing its own interest ahead of another's, including in circumstances where the adviser indirectly benefits by placing the interests of one or more clients or investors ahead of another's.<sup>176</sup> For example, a fund may not have the resources to bear its pro rata share of expenses related to a portfolio investment (whether due to insufficient reserves, the inability to call capital to cover such expenses, or otherwise). If the adviser causes another fund to bear expenses attributable to such fund, the fund bearing more than a pro rata share would be supporting the value of the other fund's investment.<sup>177</sup> Because compensation structures in the funds may differ, an adviser may have an incentive to allocate fees and expenses in a way that maximizes its compensation. Further, an adviser's ownership may vary fund by fund and thus may create an incentive to allocate fees and expenses away from the fund in which the adviser holds a greater interest.<sup>178</sup>

Moreover, we do not believe that fees and expenses attributable to unconsummated—or potential—portfolio investments should be treated differently than consummated investments, given that non-pro rata allocations in respect of

unconsummated investments generally present the same concerns as discussed above with respect to consummated investments. If more than one fund would have participated in an investment that generated “broken deal” or other fees and expenses, our view is that all such funds should bear their pro rata share of such amount.

We recognize that many advisers do not charge all their clients or potential co-investors for fees and expenses relating to unconsummated investments. For example, certain advisers offer existing investors, related persons, or third parties the opportunity to co-invest alongside the fund through one or more co-investment vehicles advised by the adviser.<sup>179</sup> Many advisers do not charge co-investment vehicles or other co-investors for fees and expenses relating to unconsummated investments. Instead, such fees and expenses are generally borne by the adviser's main fund that would have participated in the transaction, in which case the main fund would bear a disproportionate share of such amount. Such practice, however, places the interests of the other client and its underlying investors or of the other co-investors ahead of the interests of the main fund and its underlying investors. Because the other client would receive the benefit of any upside in the event the transaction goes through, we believe that such client should also generally bear the burden of any downside in the event the transaction does not go through.

Accordingly, the proposed rule does not include an exception for these types of circumstances.<sup>180</sup>

We request comment on this aspect of the proposed prohibited activities rule, including the following items:

- Should we prohibit non-pro rata fee and expense allocations as proposed? If

not, under what circumstances would non-pro rata allocations be appropriate? For example, we recognize that advisers often have policies and procedures in place that permit the adviser to allocate fees and expenses in a fair and equitable manner (or similar standard), rather than on a pro rata basis; would this better achieve our policy goals? Why or why not? What specific protections are included in such policies and procedures? Should such protections be included in the rule? Why or why not? Should there be an exception to the prohibition where an adviser determines that it is in a private fund's best interest to bear more expenses than another managed vehicle and the private fund's investors agree?

- Should the proposed rule apply to unconsummated—or potential—portfolio investments, as proposed? Do commenters agree that non-pro rata allocations of fees and expenses attributable to such investments present the same concerns as the ones discussed above with respect to consummated investments? Why or why not?

- We recognize that many co-investors do not agree to bear their pro rata share of broken or dead deal expenses. Would the proposed rule make it difficult for funds to consummate larger investments where co-investment capital is needed? Would the proposed rule cause funds to syndicate more deals post-closing once the adviser is confident that the deal will not fall through?

- Should we include an exception for co-investment vehicles (or certain other vehicles) that invest alongside another fund managed by the adviser? If so, how should we define “co-investment vehicle”? Should the rule treat single-deal co-investment vehicles differently than multi-deal co-investment vehicles? Why or why not?

- Should we define “pro rata”? Should “pro rata” be determined based on each client's ownership (or anticipated ownership) of the portfolio investment? Will advisers interpret “pro rata” differently?

- Where multiple funds invest in the same portfolio investment at different times, the first fund to invest may initially bear a higher level of fees and expenses than later funds. Should the proposed rule address fees and expense allocations among funds that invest at different times, and if so, how? If a significant amount of time has passed between the first fund's investment and the later fund's investment, should the later fund pay interest on its portion of fees and expenses? Should interest payments always apply when portfolio investments are made at different times?

<sup>175</sup> See EXAMS Private Funds Risk Alert 2020, *supra* footnote 9. See also, e.g., *In the Matter of Rialto Capital Management, LLC*, Investment Advisers Act Release No. 5558 (Aug. 7, 2020) (settled action) (alleging that adviser represented to the advisory committee, which included private fund investors as committee members, that it had data to support the adviser performing third-party services in house and charging the funds certain rates; and that the adviser misallocated fees for third-party services to the private funds when such fees also should have been allocated to the co-investment vehicles managed by the adviser).

<sup>176</sup> Because the proposed rule prohibits charging or allocating fees and expenses *related to* a portfolio investment (or potential portfolio investment) on a non-pro rata basis, advisers would not be prohibited from charging vehicles that invest alongside each other different advisory fees or other fund-level compensation. For example, a co-investment vehicle may pay lower management fees than the main fund.

<sup>177</sup> The proposed rule would not prohibit an adviser from paying a fund's pro rata portion of any fee or expense with its own capital. In addition, to the extent a fund does not have resources to pay for its share, the proposed rule would not prohibit an adviser from diluting such fund's interest in the portfolio investment in a manner that is economically equal to its pro rata portion of such fee or expense.

<sup>178</sup> On a more granular level, to the extent the adviser's personnel have varying ownership percentages in the funds, such personnel may be subject to similar conflicts of interest in determining how to allocate fees and expenses.

<sup>179</sup> In some cases, advisers use co-investment opportunities to attract new investors and retain existing investors. Advisers may offer these existing or prospective investors the opportunity to invest in co-investment vehicles with materially different fee and expense terms than the main fund (e.g., no fees or no obligation to bear broken deal expenses). These co-investment opportunities may raise conflicts of interest, particularly when the opportunity to invest arises because of an existing investment and the fund itself would otherwise be the sole investor.

<sup>180</sup> To the extent a potential co-investor has not executed a binding agreement to participate in the transaction through a co-investment vehicle (or another fund) managed by the adviser, the proposed rule would not prohibit the adviser from allocating “broken-deal” or other fees and expenses attributable to such potential co-investor to a fund that would have participated in the transaction. Advisers may be liable under the antifraud provisions of the Federal securities laws if the private fund's offering and organizational documents do not authorize such costs to be charged to the private fund.

If not, how much time should lapse before interest applies?

- The proposed rule would prohibit advisers from charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds *and other clients advised by the adviser or its related persons* have invested (or propose to invest) in the same portfolio investment. Is the scope of the phrase “other clients advised by the adviser or its related persons” broad enough? Should we revise the proposed rule to cover *any other clients, vehicles, or other persons advised by the adviser or its related persons*? Alternatively, should we revise the rule to cover all co-investment structures and arrangements?

- We recognize that a transaction counterparty may request to only contract with one fund entity, which can result in one fund being liable for its own share as well as another fund’s share of any transaction obligations, including fees and expenses. If one fund would be responsible for the liability of another fund, those funds, in certain cases, contractually agree to bear their pro rata share, often times through a contribution or reimbursement agreement. Should we prohibit this practice and thus require each fund entity to contract directly with the counterparty? Alternatively, should we require certain governance and other protections, such as contribution or reimbursement agreements, if only one fund contracts directly with the counterparty? Why or why not?

- As noted above, the proposed rule would not prohibit an adviser from charging different fund-level compensation, such as advisory fees, to vehicles that invest alongside each other in the same underlying portfolio investment. For example, a co-investment vehicle may pay lower management fees than the main fund. Is it sufficiently clear that such arrangements would not be prohibited under the proposed rule?

## 6. Borrowing

The final element of the proposed prohibited activities rule would prohibit an adviser directly or indirectly from borrowing money, securities, or other fund assets, or receiving a loan or an extension of credit, from a private fund client (collectively, a “borrowing”).<sup>181</sup> We have observed many forms of borrowing among private fund advisers and their related persons, such as using fund assets as collateral in order to

obtain a loan from a party other than the fund (*i.e.*, borrowing against fund assets), accepting a loan offered by a private fund client, and taking advantage of a continuous line of credit extended by a private fund client. For example, the Commission has brought enforcement actions alleging that private fund advisers and their related persons have used fund assets to address personal financial issues of one of the adviser’s principals, to pay for the advisory firm’s expenses,<sup>182</sup> or to bribe foreign government officials.<sup>183</sup> In these circumstances, the adviser’s related person that is the general partner of the fund sometimes, for example, causes the fund to enter into the relationship with the adviser without the knowledge or consent of the private fund investors.

When an adviser borrows from a private fund client, that adviser has a conflict of interest because it is on both sides of the transaction (*i.e.*, the adviser benefits from the loan and manages the client lender). A private fund rarely has employees of its own. Its officers, if any, are usually employed by the private fund’s adviser. The fund typically relies on the investment adviser (and, in certain cases, affiliated entities) to provide management, investment, and other services and such persons usually have authority to take actions on behalf of the private fund without the consent or approval of any other person. This structure causes a conflict of interest between the private fund (and, by extension, its investors) and the investment adviser because the interests of the fund are not necessarily aligned with the interests of the adviser. For example, when determining the interest rate for the borrowing, an investment adviser’s interest in maximizing its own profit by negotiating (or setting) a low rate may conflict with its duty to act in the best interests of the fund.

<sup>182</sup> See *In the Matter of Monsoon Capital, LLC*, Investment Advisers Act Release No. 5490 (Apr. 30, 2020) (settled action) (alleging that the owner of a private fund adviser borrowed \$1 million from a private fund client in order to settle a personal trade); *Resilience Management, LLC*, Investment Advisers Act Release No. 4721 (June 29, 2017) (settled action) (alleging that a private fund adviser borrowed money from funds in order to pay adviser’s expenses; and that the CEO of the adviser borrowed money to pay for personal expenses); *SEC v. Philip A. Falcone*, [U.S. District Court Southern District of New York, Consent] (Aug. 16, 2013) (hedge fund adviser borrowed from hedge fund at low interest rate in order to repay adviser’s personal taxes. Adviser failed to disclose the loan to investors for five months).

<sup>183</sup> See *In the Matter of Och-Ziff Capital Management Group, LLC*, Investment Advisers Act Release No. 4540 (Sept. 29, 2016), at para. 3 (settled action) (alleging that a private fund adviser authorized the use of investor funds to pay bribes to foreign government officials in order to obtain or retain business for its parent company and its business partners).

Moreover, this practice may prevent the fund client from using those assets to further the fund’s investment strategy. Even where disclosed (and potentially consented to by an advisory board, such as an LPAC), this practice presents a conflict of interest that is harmful to investors because, as a result of the unique structure of private funds, only certain investors with specific information or governance rights (such as representation on the LPAC) would potentially be in a position to negotiate or discuss the terms of the borrowing with the adviser, rather than all of the private fund’s investors.

The proposed rule would not prevent the adviser from borrowing from a third party on the fund’s behalf or from lending to the fund. Private funds sometimes use subscription lines of credit, also known as credit facilities, to address financing needs. For example, some private funds use these facilities to address short-term financing needs when the fund makes investments or participates in a co-investment. Other private funds use such facilities for long-term financing purposes, for example, when an infrastructure fund decides to use a long-term facility during the development stage of a project before a capital call. In these circumstances, the adviser is not borrowing from the fund. Similarly, advisers sometimes lend money to a fund in order to address start-up costs or to manage other expenses (for example, an adviser may pay legal or operating expenses of several fund clients and then seek reimbursement once the expenses have been allocated among the advised private funds). Allowing advisers to continue this practice would provide private funds access to capital, especially when they are in the early stages of attracting investors. Advisers lending to private funds they manage on terms that do not include excessive interest rates or other abusive practices do not raise the same concerns that advisers borrowing from private funds they manage raises because there are fewer opportunities for abusive practices when the adviser is providing money to, rather than taking money from, the private fund.

We request comment on this aspect of the proposed prohibitions rule, including the following:

- Should we broaden the scope of the prohibition on borrowings to prevent a private fund adviser from borrowing from co-investment vehicles or other accounts that are not private funds?

<sup>181</sup> Proposed rule 211(h)(2)–1(a)(7).

• Should we broaden the proposed prohibition to apply when an adviser lends to the fund?<sup>184</sup>

• Should the proposed rule exclude certain activity from the prohibition (e.g., scenarios where a private fund makes tax advances or tax distributions to its general partner (or similar control person) to ensure that the general partner and its investment professionals are able to pay their personal taxes derived from the general partner's interest in the fund)? If so, what activity should we exclude and why?

• Are there situations in which a fund would agree to lend a start-up adviser money for initial costs and employee salaries? Are there situations in which a private fund client should be able to make a loan to a private fund adviser because the economic terms would be favorable to the private fund? How would we determine that the terms are favorable to the private fund?

• Should the proposed rule be expanded to prohibit an adviser from borrowing against a private fund client's bank account or other assets, where the lender may be a third party (rather than the private fund)? Why or why not?

• Should we amend Form ADV and/or Form PF to require advisers to report information about an adviser or its related person lending to, or borrowing from, private funds or other clients? Why or why not? For example, should we require advisers to report whether they engage in this practice and to provide an aggregate amount or range of such loans or borrowings?

• Recognizing the limitations of private fund governance mechanisms, as discussed above, should we permit borrowing if it is subject to specific governance and other protections (e.g., advance disclosure to all investors, advance disclosure to an LPAC or similar body, consent of a governing body such as an LPAC, and/or consent of a majority or supermajority of investors)? Should we require private fund advisers to make ongoing disclosures to investors and/or governing bodies of the status of such borrowings? Why or why not?

• Should the rule include any full or partial exclusions for certain transactions that may not involve conflicts of interest or that may involve certain third parties that ameliorate the conflicts of interest? For example, should we provide an exclusion if the

terms of the borrowing are set by an independent third party and such third party has the authority to act on behalf of the fund in the event of a default by the adviser? Why or why not?

• Do commenters envision unintended consequences of this proposed prohibition, such as in circumstances where an adviser's related person has its own commercial relationship with the fund?

• Should the rule prohibit (or otherwise restrict) advisers from lending to private funds they manage on terms that include excessive interest rates or other abusive practices? To what extent and under what circumstances does this practice occur? Does it raise similar concerns to borrowing?

#### *E. Preferential Treatment*

In order to address specific types of preferential treatment that have a material negative effect on other investors in the private fund or in a substantially similar pool of assets, we also propose to prohibit all private fund advisers, regardless of whether they are registered with the Commission, from providing preferential terms to certain investors regarding redemption or information about portfolio holdings or exposures.<sup>185</sup> We also propose to prohibit these advisers from providing any other preferential treatment to any investor in the private fund unless the adviser provides written disclosures to prospective and current investors in a private fund regarding all preferential treatment the adviser or its related persons are providing to other investors in the same fund.<sup>186</sup> Whether any terms are "preferential" would depend on the facts and circumstances.

Side letters or side arrangements are generally agreements among the investor, general partner, adviser, and/or the private fund that provide the investor with different or preferential terms than those set forth in the fund's governing documents.<sup>187</sup> Side letters generally grant more favorable rights and privileges to certain preferred investors (e.g., seed investors, strategic investors, those with large

commitments, and employees, friends, and family) or to investors subject to government regulation (e.g., the Employee Retirement Income Security Act ("ERISA"), the Bank Holding Company Act, or public records laws). Advisers often provide these terms for strategic reasons that benefit the adviser. In some cases, these terms can also benefit the fund, for example, if the adviser signs a side letter with a large, early stage investor, then the fund will increase its assets. Increased fund assets may enable the fund to make certain investments, for example of a larger size, which ultimately benefits all investors. However, preferential terms do not necessarily benefit the fund or other investors that are not party to the side letter agreement and, at times, we believe these terms can have a material, negative effect on other investors.

We recognize that advisers provide a range of preferential treatment, some of which does not necessarily disadvantage other fund investors. In this case, we believe that disclosure is appropriate because it would allow investors to make their own assessment. Other types of preferential treatment, however, have a material, negative effect on other fund investors or investors in a substantially similar pool of assets. We propose to prohibit these types of preferential treatment because they are sales practices that present a conflict of interest between the adviser and the private fund client that are contrary to the public interest and protection of investors. We have tailored the proposed rule to address these different ends of the spectrum.

#### *Prohibited Preferential Redemptions*

We propose to prohibit a private fund adviser, including indirectly through its related persons, from granting an investor in the private fund or in a substantially similar pool of assets the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets.<sup>188</sup>

Different types of private funds and other pooled vehicles offer different redemption opportunities, and an investor's ability to exit or withdraw differs significantly depending on the fund's or pool's liquidity profile. While open-end private funds typically allow

<sup>185</sup> Proposed rule 211(h)(2)–3(a)(1) and (2).

<sup>186</sup> Proposed rule 211(h)(2)–3(b).

<sup>187</sup> The proposed rule would prohibit certain types of preferential treatment and would require an adviser to disclose other types of preferential treatment that the adviser or its related persons (acting on their own behalf and/or on behalf of the fund) provide to investors. Therefore, the proposed rule typically would apply when the adviser's related person is the general partner (or similar control person) and is a party (and/or caused the private fund to be a party, directly or indirectly) to a side letter or other arrangement with an investor, even if the adviser itself (or any related person of the adviser) is not a party to the side letter or other arrangement.

<sup>184</sup> See, e.g., *In the Matter of Clean Energy Capital LLC*, Investment Advisers Act Release No. 3955 (Oct. 17, 2014) (settled action) (alleging that a private equity fund adviser caused the funds to borrow money from the adviser without providing notice to investors and by pledging the private equity funds' assets as collateral).

<sup>188</sup> Proposed rule 211(h)(2)–3(a)(1). For purposes of the prohibitions in proposed rule 211(h)(2)–3(a)(1) or (2), whether an adviser could have a reasonable expectation that the preferential term would have a material, negative effect on other investors in the same private fund or in a substantially similar pool of assets would depend on the facts and circumstances.



for periodic redemptions, closed-end private funds typically do not permit investors to withdraw their investments without consent. We understand that some private fund advisers grant one or more investors more favorable redemption rights. For example, a large investor may negotiate, through a side letter or other side arrangement, to be able to redeem its interest in the fund before, or more frequently than, other investors. Advisers enter into such arrangements in exchange for, for example, a large investor agreeing to invest in the fund or a large investor agreeing to participate in a future fundraising of an investment vehicle that the adviser manages.<sup>189</sup> Our staff also has observed scenarios where an adviser establishes investment vehicles that invest side-by-side along with the private fund that have better liquidity terms than the terms provided to investors in the private fund.<sup>190</sup>

We believe that granting preferential liquidity terms on terms that the adviser reasonably expects to have a material, negative effect on other investors in the private fund or in a substantially similar pool of assets is a sales practice that is harmful to the fund and its investors. In granting preferential liquidity rights to a large investor, the adviser stands to benefit because its fees increase as fund assets under management increase. As noted above, the adviser attracts preferred investors to invest in the fund by offering preferential terms, such as more favorable liquidity rights. While the fund also may experience some benefits, including the ability to attract additional investors and to spread expenses over a broader investor and asset base, there are scenarios where the preferential liquidity terms harm the fund and other investors. For example, if an adviser allows a preferred investor to exit the fund early and sells liquid assets to accommodate the preferred investor's redemption, the fund may be left with a less liquid pool of assets, which can inhibit the fund's ability to carry out its investment strategy or promptly satisfy other investors' redemption requests. This can dilute remaining investors' interests in the fund and make it difficult for those investors to mitigate their investment losses in a down market cycle. These concerns can also apply when an adviser provides favorable redemption rights to an investor in a substantially similar pool of assets, such as another feeder fund investing in the same master

fund. The Commission believes that the potential harms to other investors justify this restriction.

#### Prohibited Preferential Transparency

We propose to prohibit an adviser and its related persons from providing information regarding the portfolio holdings or exposures of the private fund or of a substantially similar pool of assets to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets.<sup>191</sup>

Private fund advisers, in some cases, disclose information about portfolio holdings or exposures to certain, but not all, investors in the private fund or in a substantially similar pool of assets. For example, an investor may request certain information about characteristics of the fund's holdings to satisfy the investor's internal reporting obligations. An investor can negotiate to receive certain types of information that is not widely available to all investors; however, an investor's success in obtaining such terms may depend on factors including the size of its capital commitment.<sup>192</sup>

Selective disclosure of portfolio holdings or exposures can result in profits or avoidance of losses among those who were privy to the information beforehand at the expense of investors who did not benefit from such transparency. In addition, such information could enable an investor to trade in portfolio holdings in a way that "front-runs" or otherwise disadvantages the fund or other clients of the adviser. Granting preferential transparency, for example through side letters, presents a sales practice that is contrary to the public interest and protection of investors because it preferences one investor at the expense of another. An adviser may agree to provide preferential information rights to a certain investor in exchange for something of benefit to the adviser. The proposed rule is designed to neutralize the potential for private fund advisers to treat portfolio holdings information as a commodity to be used to gain or maintain favor with particular investors.<sup>193</sup> We believe that this

proposed prohibition would curtail activity that harms investors.

#### Substantially Similar Pool of Assets

The proposed rule would define the term "substantially similar pool of assets" as a pooled investment vehicle (other than an investment company registered under the Investment Company Act of 1940 or a company that elects to be regulated as such) with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the adviser or its related persons.<sup>194</sup> Whether a pool of assets managed by the adviser is "substantially similar" to the private fund requires a facts and circumstances analysis. A pool of assets with a materially different target return or sector focus, for example, would likely not have substantially similar investment policies, objectives, or strategies as the subject private fund, depending on the facts and circumstances.

The types of asset pools that would be included in this term would include a variety of pools, regardless of whether they are private funds. For example, this term would include limited liability companies, partnerships, and other organizational structures, regardless of the number of investors; feeders to the same master fund; and parallel fund structures and alternative investment vehicles. It would also include pooled vehicles with different base currencies and pooled vehicles with embedded leverage to the extent such pooled vehicles have substantially similar investment policies, objectives, or strategies as those of the subject private fund. In addition, an adviser would be required to consider whether its proprietary accounts meet the definition of "substantially similar pool of assets."

This proposed definition is designed to capture most commonly used fund structures and prevent advisers from structuring around the prohibitions on preferential treatment. For example, in a master-feeder structure, some advisers create custom feeder funds for favored investors. Without a comprehensive definition of substantially similar pool of assets, the proposed rule would not preclude such advisers from providing preferential treatment to investors in these custom feeder funds to the detriment of investors in standard commingled feeder funds within the master-feeder structure. While similar concerns may exist for separately managed accounts, this proposed rule is designed to address the specific concerns that arise out of the lack of

<sup>189</sup> Proposed rule 211(h)(2)–3(a)(2).

<sup>192</sup> See Professor Clayton Article, *supra* footnote 7, at 316 (noting that large investors can often negotiate fee discounts or other side letter benefits that smaller investors would not receive).

<sup>193</sup> See *Selective Disclosure and Insider Trading*, Securities Act of 1933 Release No. 33–7881 (Aug. 15, 2000) [65 FR 51715 (Aug. 24, 2000)].

<sup>194</sup> Proposed rule 211(h)(1)–1.

<sup>189</sup> See *supra* section II.E. (Preferential Treatment) (discussing side letters as a sales practice).

<sup>190</sup> See EXAMS Private Funds Risk Alert 2020, *supra* footnote 9.

transparency and governance mechanisms prevalent in the private fund structure.

#### Other Preferential Treatment

The proposed rule also would prohibit other preferential terms unless the adviser provides certain written disclosures to prospective and current investors.<sup>195</sup> We believe that certain types of preferential terms raise relatively minor concerns, if fully disclosed. However, we are concerned that an adviser's current sales practices do not provide all investors with sufficient detail regarding preferential terms granted to other investors.<sup>196</sup> For example, an adviser to a private equity fund may provide "excuse rights" (*i.e.*, the right to refrain from participating in a specific investment the private fund plans to make) to certain private fund investors. Advisers sometimes grant excuse rights to accommodate an investor's unique investment restrictions, such as a mandate to avoid investment in portfolio companies that do not meet certain environmental, social, or governance standards. This lack of transparency prevents investors from understanding the scope of preferential terms granted. The proposed rule would prohibit these terms unless the adviser provides information about them in a written notice.

Increased transparency would better inform investors regarding the breadth of preferential treatment, the potential for those terms to affect their investment in the private fund, and the potential costs (including compliance costs) associated with these preferential terms.<sup>197</sup> This disclosure would help investors shape the terms of their relationship with the adviser of the private fund. For example, they might also learn of similarly situated investors who are receiving a better deal with respect to fees or other terms. An investor also may learn that the adviser provided fee discounts to a large, early stage investor. Or, an investor may learn that the adviser granted a strategic investor the right to increase its investment in the fund even though the fund is closed to new investors or to additional investments by other existing

investors. This may lead the investor to request additional information on other benefits that the adviser's related persons or large investors receive, such as co-investment rights. An investor may then be able to understand better certain potential conflicts of interest and the risk of potential harms or other disadvantages.

Under the proposed rule, an adviser would need to describe specifically the preferential treatment to convey its relevance. For example, if an adviser provides an investor with lower fee terms in exchange for a significantly higher capital contribution than paid by others, we do not believe that mere disclosure that some investors pay a lower fee is specific enough. Instead, we believe an adviser must describe the lower fee terms, including the applicable rate (or range of rates if multiple investors pay such lower fees), in order to provide specific information as required by the proposed rule. An adviser could comply with the proposed disclosure requirements by providing copies of side letters (with identifying information regarding the other investors redacted).<sup>198</sup> Alternatively, an adviser could provide a written summary of the preferential terms provided to other investors in the same private fund, provided the summary specifically describes the preferential treatment.

The timing of the proposed rule's delivery requirements would differ depending on whether the recipient is a prospective or existing investor in the private fund. For a prospective investor the notice needs to be provided, in writing, prior to the investor's investment. For an existing investor, the adviser would have to "distribute" the notice annually if any preferential treatment is provided to an investor since the last notice.<sup>199</sup> An adviser would satisfy its distribution requirement to current investors by sending the written notice to all of the private fund's investors. If an investor is a pooled investment vehicle that is in a control relationship with the adviser, the adviser must look through that pool in order to send the notice to investors

in those pools.<sup>200</sup> We believe this aspect of the proposed rule would require advisers to reassess periodically the preferential terms they provide to investors in the same fund, and investors would benefit from receiving periodic updates on preferential terms provided to other investors in the same fund. We also believe that providing this information annually would not overwhelm investors with disclosure.

We request comment on this aspect of the proposed rule, including the following:

- Should the proposed rule apply only to SEC-registered advisers and advisers that are required to be registered with the SEC instead of all advisers, as proposed?
- Should we prohibit *all* preferential treatment instead of the proposed approach, which is to prohibit certain types of preferential treatment (*i.e.*, liquidity and transparency terms that an adviser reasonably expects to have a material, negative effect) and prohibit all other types of preferential treatment unless disclosed? Why or why not?
- Should the proposed prohibitions apply only to terms that the adviser reasonably expects *to have* a material, negative effect, as proposed? Alternatively, should the proposed prohibitions apply more broadly to terms that the adviser reasonably expects *could have* a material, negative effect? Why or why not?
- Should we prohibit *all* preferential liquidity terms, rather than just those that the adviser reasonably expects to have a material, negative effect on other investors in that fund or in a substantially similar pool of assets? Why or why not?
- Are there certain investors who require different liquidity terms (*e.g.*, ERISA plans, government plans)? If so, which types of investors and what liquidity terms do they require? How do advisers currently accommodate such investors without disadvantaging other investors in the private fund? Should the proposed rule permit different liquidity terms for these investor types? If so, should the proposed rule impose restrictions in order to protect other private fund investors? If so, which types of restrictions?
- Are there practices related to liquidity and redemption rights that the proposed rule should explicitly address (*e.g.*, in-kind distribution of securities in connection with a redemption, side-pocketing of illiquid investments, discounting or eliminating the management fee while a fund suspends

<sup>195</sup> Proposed rule 211(h)(2)–3(b).

<sup>196</sup> See Juliane Begenau and Emil Siriwardane, *How Do Private Equity Fees Vary Across Public Pensions?*, Harvard Business School (2020), available at <https://www.hbs.edu/faculty/Pages/item.aspx?num=57534>.

<sup>197</sup> The Alternative Investment Fund Managers Directive (AIFMD) includes transparency obligations requiring disclosure to all investors of any preferential treatment received by a particular investor, including by way of a side letter. See AIFMD Art. 23.

<sup>198</sup> We are not proposing to require the adviser to disclose the names or even types of investors provided preferential terms as part of this proposed disclosure requirement.

<sup>199</sup> As a practical matter, a private fund that does not admit new investors or provide new terms to existing investors would not need to deliver an annual notice. However, an adviser that enters into a side letter after the closing date of the fund would need to disclose any covered preferential terms in the side letter to investors that are locked into the fund.

<sup>200</sup> See *supra* section II.A.3 (Preparation and Distribution of Quarterly Statements).

liquidity)? For example, should the proposed rule prohibit in-kind distribution of securities in connection with a redemption, side-pocketing illiquid investments, or discounting or eliminating the management fee while a fund suspends liquidity? Alternatively, should the proposed rule include an exception for these activities?

- Should we prohibit *all* preferential transparency regarding holdings or exposures of the fund or pool, rather than just prohibiting preferential transparency regarding holdings or exposures that the adviser reasonably expects to have a material, negative effect on other investors in that fund or in a substantially similar pool of assets? Why or why not?

- Should we define, or provide guidance on, when preferential redemption terms or preferential information rights would have a material, negative effect on other investors? If so, what should be some determining factors? Would it be relevant that the redemption terms would cause another investor to reconsider its investment decision? Please explain your answer. Should we clarify whether an adviser could disclose information about holdings or exposures of the fund or a substantially similar pool of assets on a delayed basis without violating the proposed prohibition? Should the proposed rule expressly require disclosure to investors after a specified period? If so, what period?

- Are transparency concerns, especially with regard to information that could have an impact on an investor's decision to redeem, more prominent with certain fund types (e.g., hedge funds, private equity funds)? If so, which types and why?

- Should we exempt certain types of private funds from the written notice requirements of the proposed preferential treatment rule?<sup>201</sup> If so, which types of funds and why?

- Should we restrict the use of side letters and side arrangements so that they can only be used to address certain matters such as, for example, legal, regulatory, or tax issues that are specific to an investor?

- Should the rule's prohibitions on preferential terms extend to a substantially similar pool of assets or apply only to each private fund separately?

- The proposed definition of "substantially similar pool of assets" would not include co-investments by a separately managed account managed by the adviser or its related persons. Is

this definition too narrow? Why or why not? Would the proposed definition appropriately capture similar funds? Should it, for example, include circumstances where a private fund invests alongside a separately managed account? Why or why not? Should the definition include a co-investment vehicle that is structured as a pool of assets that invests in a single entity and where the private fund invests in the same entity?

- Should we limit "substantially similar pool of assets" to pools the adviser or its related persons manage, as proposed? Is the proposed definition too broad or too narrow? The proposed definition would require the pool of assets to have substantially similar (i) investment policies, (ii) objectives, or (iii) strategies to those of the private fund. Should we change "or" to "and" and instead require that the pool satisfy all three requirements (i.e., have substantially similar investment policies, objectives, *and* strategies)? Should we instead require that the pool satisfy only two of the three criteria? For example, should the definition only require the pool of assets to have substantially similar objectives and strategies (and not policies) to those of the private fund? Are there other unique characteristics or factors, such as the target rate of return, the proposed definition should address? Should the definition exclude multi-share class private funds? If so, why?

- Should we narrow the scope of the term "substantially similar pool of assets" to only include pooled vehicles that invest or generally invest *pari passu* with the private fund? Why or why not?

- Do commenters agree that we should prohibit other preferential terms unless the adviser provides specific information regarding those terms to prospective and current private fund investors? Would these disclosures benefit these investors? Should we require advisers to provide additional information in the written notices? If so, what information? Should the rule specify what information is required to be included in the notice?

- Instead of requiring advisers to provide or distribute the written notice, should we require advisers to only provide or distribute the written notice upon request?

- With regard to current investors, the proposed rule would require advisers to disclose preferential treatment *provided* by the adviser or its related persons. Instead or in addition, should we require advisers to disclose preferential treatment that it has offered to other investors in the same fund?

- Should we require advisers to provide advance written notice to prospective investors, as proposed? Should we define "prospective investor" in the proposed rule? If so, how should we define this term and why? For example, should we define "prospective investor" as any person or entity that has expressed an interest in a private fund advised by the adviser?<sup>202</sup> If not, should we provide guidance regarding how advisers can identify prospective investors? Should we clarify how advisers that use intermediaries, investment consultants, or other third parties to introduce prospective investors would comply with the proposed rule? For example, should we state that advisers must treat the intermediaries, investment consultants, or other third parties as the prospective investor in these circumstances? Should the definition include prospective transferees? Why or why not?

- The proposed rule would require the adviser to provide the written notice "prior to the investor's investment in the private fund." Should we prescribe how far in advance of the investment an adviser must provide such notice? For example, should we require an adviser to provide the written notice at least two business days prior to the date of investment? Should such period be longer or shorter? If so, why? Should the proposed rule require advisers to provide notice to prospective investors within a certain number of days before the investor submits its complete subscription agreement (or equivalent)? Alternatively, should the proposed rule require the adviser to provide the notice at the time an investor receives the private fund's offering and organizational documents (e.g., limited partnership agreement, private placement memorandum)? Should we instead require that notice be sent prior to some other action or event? If so, what action or event and why? Should the proposed rule require advisers to update disclosure they previously provided, for example, to include preferential treatment that an adviser granted after some investors decided to invest, but before closing?

- What impact would the advance written notice requirement have on "most favored nation" clauses ("MFN clauses") granted to other fund investors?<sup>203</sup>

<sup>202</sup> See CFA Institute Global Investment Performance Standards for Firms: Glossary, CFA Institute (2020) (defining "prospective investor").

<sup>203</sup> In an MFN clause, an adviser or its related person generally agrees to provide an investor with contractual rights or benefits that are equal to or

<sup>201</sup> See proposed rule 211(h)(2)–(3)(b).

- Should the rule require disclosure of all preferential treatment, as proposed, or should the rule have a narrower or broader scope?

- Should the proposed rule require the adviser to disclose how it memorialized the preferential treatment (e.g., formal written side letter, email)?

- The proposed rule would require the adviser to provide *written* notice. Should the proposed rule instead allow advisers to disclose this information orally and keep a record evidencing such oral disclosure? Why or why not?

- The proposed rule would require the adviser to provide notice on an annual basis to current investors, if the adviser or its related persons provided any preferential treatment to other investors in the same private fund since the last written notice. The proposed rule does not specify whether the adviser must provide this on a calendar year basis, the adviser's fiscal year, or on a rolling annual basis. Should the rule specify precisely when the annual period begins and ends? Why or why not? If so, what should the beginning and ending dates be? Instead of an annual notice, should we require an adviser to provide the notice within 30 days of providing any new preferential treatment to an investor in the fund?

- Should we require an adviser to document the years during which it has not provided any preferential treatment and therefore need not distribute or provide a written notice to current investors or prospects, respectively? Why or why not? If an adviser has not provided preferential treatment to any investors, or has not done so during the applicable time period, should we require an adviser to send current investors and prospects a written notice confirming that it does not have any preferential treatment to disclose? Why or why not?

- The proposed rule would require advisers to provide or distribute a written notice that provides "specific" information about preferential treatment. Should the proposed rule define "specific" or use another term to describe the required level of detail?

#### 1. Recordkeeping for Preferential Treatment

We propose amending rule 204–2 under the Advisers Act to require advisers registered with the Commission to retain books and records to support their compliance with the proposed preferential treatment rule.<sup>204</sup> In connection with the written notices

better than the rights or benefits provided to certain other investors.

<sup>204</sup> Proposed rule 211(h)(2)–3(b).

required by proposed rule 211(h)(2)–3, advisers would be required to retain copies of all written notices sent to current and prospective investors in a private fund pursuant to that rule.<sup>205</sup> In addition, advisers would be required to retain copies of a record of each addressee and the corresponding dates sent, addresses, and delivery method for each addressee. These proposed requirements would facilitate our staff's ability to assess an adviser's compliance with the proposed rule and would similarly enhance an adviser's compliance efforts.

We request comment on this aspect of the proposed rule:

- Would the proposed recordkeeping requirement be overly burdensome for advisers? Why or why not?

- Would advisers face more difficulty retaining records regarding prospective investors as compared to retaining records for current investors? Would it be more difficult for advisers to keep track of prospective investors? For example, prospective investors may express interest in a private fund, but may not actually invest. Should we only require advisers to retain records regarding prospective investors that invest in the private fund?

- The books and records rule under the Advisers Act applies to SEC-registered advisers. Should we adopt a recordkeeping obligation that would require other advisers (such as exempt reporting advisers) to retain the written notices that proposed rule 211(h)(2)–3 would require? Why or why not?

### III. Discussion of Proposed Written Documentation of all Advisers' Annual Reviews of Compliance Programs

We are proposing to amend the Advisers Act compliance rule to require all SEC-registered advisers to document the annual review of their compliance policies and procedures in writing.<sup>206</sup> We believe that such a requirement would focus renewed attention on the importance of the annual compliance review process. In addition, we believe that the proposed amendment would result in records of annual compliance reviews that would allow our staff to determine whether an adviser has complied with the review requirement of the compliance rule.<sup>207</sup>

<sup>205</sup> See *supra* footnote 106 (describing the record retention requirements under the books and records rule). See also proposed amendments to rule 204–2(a)(7)(v).

<sup>206</sup> Proposed rule 206(4)–7(b).

<sup>207</sup> See *Compliance Programs of Investment Companies and Investment Advisers*, Investment Advisers Act Release No. 2204 (Dec. 17, 2003) [38 FR 74714 (Dec. 24, 2003)] ("Compliance Rule Adopting Release"). When adopting the compliance

The compliance rule currently requires advisers to review, no less frequently than annually, the adequacy of their compliance policies and procedures and the effectiveness of their implementation. The annual review requirement was intended to require advisers to evaluate periodically whether their compliance policies and procedures continue to work as designed and whether changes are needed to assure their continued effectiveness.<sup>208</sup> As we stated in the Compliance Rule Adopting Release, "the annual review should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies and procedures."

Based on staff experience, some investment advisers do not make and preserve written documentation of the annual review of their compliance policies and procedures. The compliance rule does not expressly require written documentation.<sup>209</sup> Our examination staff relies on documentation of the annual review to help the staff understand an adviser's compliance program, determine whether the adviser is complying with the rule, and identify potential weaknesses in the compliance program. Without documentation that the adviser

rule, the Commission adopted amendments to the books and records rule requiring advisers to make and keep true a copy of the adviser's compliance policies and procedures and any records documenting an adviser's annual review of its compliance policies and procedures. The Commission noted that this recordkeeping requirement was designed to allow our examination staff to determine whether the adviser has complied with the compliance rule. See also rule 204–2(a)(17)(i)–(ii).

<sup>208</sup> See *Compliance Programs of Investment Companies and Investment Advisers*, Investment Advisers Act Release No. 2107 (Feb. 5, 2003) [68 FR 7038 (Feb. 11, 2003)] ("Compliance Rule Proposing Release").

<sup>209</sup> The Commission has identified instances where it alleged no annual review of the compliance program was conducted. See, e.g., *In re du Pasquier & Co., Inc.*, Investment Advisers Act Release No. 4004 (Jan. 21, 2015) (settled action) (alleging that the adviser failed to annually review the adequacy of its compliance policies and procedures and the effectiveness of their implementation); *In re Pekin Singer Strauss Asset Management Inc., et al.*, Investment Advisers Act Release No. 4126 (June 23, 2015) (settled action) (alleging that the adviser failed to complete timely annual compliance program reviews); *In the Matter of Hudson Hous. Capital, LLC*, Investment Advisers Act Release No. 5047 (Sept. 25, 2018) (settled action) (alleging that the adviser failed to review its policies and procedures at least annually); *In the Matter of ED Capital Management, LLC*, Investment Advisers Act Release No. 5344 (Sept. 13, 2019) (settled action) (alleging that the adviser failed to conduct the required annual reviews of its written policies and procedures).

conducted the review, including information about the substance of the review, our staff has limited visibility into the adviser's compliance practices. The proposed amendment to rule 206(4)–7 would establish a written documentation requirement applicable to all advisers.<sup>210</sup>

Proposed rule 206(4)–7(b) does not enumerate specific elements that advisers must include in the written documentation of their annual review. The written documentation requirement is intended to be flexible to allow advisers to continue to use the review procedures they have developed and found most effective. For example, some advisers may review the adequacy of their compliance policies and procedures (or a subset of those compliance policies and procedures) and the effectiveness of their implementation on a quarterly basis. In such a case, we believe that the written documentation of the annual review could comprise written quarterly reports.

The regulations in 17 CFR 270.38a–1 (rule 38a–1 under the Investment Company Act), the compliance rule applicable to registered investment companies and business development companies (collectively “registered funds”), do not require written documentation of a registered fund’s annual review of its compliance policies and procedures.<sup>211</sup> However, rule 38a–1 requires a registered fund’s CCO to provide a written report to the registered fund’s board of directors, at least annually, that addresses: (i) The operation of the compliance policies and procedures of the registered fund and each investment adviser, principal underwriter, administrator, and transfer agent of the registered fund; (ii) any material changes made to those policies and procedures since the date of the last report; (iii) any material changes to the policies and procedures recommended

as a result of the registered fund’s annual review of its policies and procedures; and (iv) each material compliance matter that occurred since the date of the last report.<sup>212</sup> With registered funds, written accountability has been helpful to ensure compliance with the Federal securities laws, and the proposed requirements for investment advisers are intended to provide similar benefits.<sup>213</sup> The proposed required written documentation of the annual review under the compliance rule is meant to be made available to the Commission and the Commission staff and, therefore, should promptly be produced upon request.<sup>214</sup> Commission staff has observed claims of the attorney-client privilege, the work-product doctrine, or other similar protections over required records, including any records documenting the annual review under the compliance rule, based on reliance on attorneys working for the adviser in-house or the engagement of law firms and other service providers (e.g., compliance consultants) through law firms.<sup>215</sup> Attempts to shield from, or unnecessarily delay production of any non-privileged record is inconsistent with prompt production obligations and undermines Commission staff’s ability to conduct examinations. Prompt access to all records is critical for protecting investors and to an effective and efficient examination program.

We request comment on the proposed amendments to the compliance rule:

- Should we expressly require advisers to document the annual review

of their compliance policies and procedures in writing, as proposed? If not, why?

- Should we specify certain elements that must be included in the written documentation of the annual review? For example, should we require the written documentation to address matters similar to those that are required in the chief compliance officer’s written report to a registered fund’s board of directors pursuant to rule 38a–1 under the Investment Company Act? Despite the limitations of private fund governance mechanisms, as discussed above, should we require the new documentation to be provided to LPACs, directors, or other governing bodies of private funds? Why or why not?

- Are there alternate means to document an adviser’s annual review of its compliance program?

- Are there exceptions to the written documentation requirement that we should adopt?

#### IV. Transition Period and Compliance Date

We are proposing a one-year transition period to provide time for advisers to come into compliance with these new and amended rules if they are adopted. Accordingly, we propose that the compliance date of any adoption of this proposal would be one year following the rules’ effective dates, which would be sixty days after the date of publication of the rules in the **Federal Register**.

Staff in the Division of Investment Management is reviewing staff statements, including staff no-action letters and staff interpretative letters, to determine whether any statements, or portions thereof, should be withdrawn or modified in connection with any adoption of this proposal. Upon the adoption of any rule, some letters and other staff statements, or portions thereof, may be moot, superseded, or otherwise inconsistent with the rule and, therefore, would be withdrawn or modified. If interested parties believe that certain letters or other staff statements, or portions thereof, should be withdrawn or modified, they should identify the letter or statement, state why it is relevant to the proposed rule, how it or any specific portion thereof should be treated, and the reason therefor. Interested parties also should explain any concerns with the withdrawal or modification of any staff statements and letters on this topic.

We request comments on the proposed transition period:

- Do commenters agree that a one-year transition period following each

<sup>210</sup> The adviser would be required to maintain the written documentation of its annual review in an easily accessible place for at least five years after the end of the fiscal year in which the review was conducted, the first two years in an appropriate office of the investment adviser. See rule 204–2(a)(17)(ii) and (e)(1).

<sup>211</sup> While business development companies (as defined in the Investment Company Act) are exempt from the registration provisions of that Act, we include them within the term “registered funds” for ease of reference. See 15 U.S.C. 80a–2(a)(48); 15 U.S.C. 80a–6(f). Rule 38a–1(a)(3) under the Investment Company Act requires a registered fund to review, no less frequently than annually, the adequacy of the policies and procedures of the registered fund and of each investment adviser, principal underwriter, administrator, and transfer agent and the effectiveness of their implementation. Rule 38a–1(d) under the Investment Company Act requires a registered fund to maintain any records documenting the fund’s annual review.

<sup>212</sup> Rule 38a–1(a)(4)(iii) under the Investment Company Act. For purposes of rule 38a–1, a “material compliance matter” is defined as any compliance matter about which the registered fund’s board of directors would reasonably need to know to oversee fund compliance, including violations of the Federal securities laws by the registered fund. See rule 38a–1(e)(2) under the Investment Company Act.

<sup>213</sup> Our staff has observed that registered funds also generally retain these reports with their board meeting minutes, which aids our staff’s ability to assess compliance with rule 38a–1. See rule 31a–1(b)(4) under the Investment Company Act (requiring registered investment companies to maintain and keep current certain books, accounts, and other documents, including minute books of directors’ or trustees’ meetings; and minute books of directors’ or trustees’ committee and advisory board or advisory committee meetings).

<sup>214</sup> In connection with the written report required under rule 38a–1, the Compliance Rule Adopting Release stated that “[a]ll reports required by our rules are meant to be made available to the Commission and the Commission staff and, thus, they are not subject to the attorney-client privilege, the work-product doctrine, or other similar protections.” See Compliance Rule Adopting Release, *supra* footnote 207, at n.94.

<sup>215</sup> Staff also has observed delays in production of other non-privileged records. Delays undermine the staff’s ability to conduct examinations, and may be inconsistent with production obligations.

rule's effective date if adopted is appropriate? Should the period be shorter or longer? For example, would six months be an appropriate amount of time? Alternatively, would eighteen months be necessary?

- Should the transition period be the same for all of the proposed new and amended rules if adopted? Should we have different compliance dates for each proposed rule? Why or why not, and for which rules?

- Should the transition period be the same for all advisers subject to the proposed rules, if adopted?

Alternatively, should we adopt a tiered transition period for smaller or larger entities? For example, should we provide an additional six months in the transition period for smaller entities (or some other shorter or longer period)? How should we define smaller entities for this purpose?

- Should advisers to certain fund types have a longer (or shorter) transition period? Would compliance with some or all of the proposed rules be more complex for advisers to certain fund types, such as private equity, venture capital, real estate or other similar closed-end private funds, than for advisers to other fund types, such as hedge funds or other similar open-end private funds?

- The proposed quarterly statement rule would require advisers to report performance since the fund's inception. Should we allow funds that existed before the compliance date of the proposed rule to include performance information only for periods beginning on or after the proposed rule's compliance date? Should the proposed rule include a maximum period of time that funds that are in existence as of the compliance date must look back in order to report performance, fees, and expenses? Is it common practice for older funds (e.g., hedge fund inception 30 years ago) to retain records to support that performance? Would it be burdensome for advisers to provide since-inception performance information?

## V. Economic Analysis

### A. Introduction

We are mindful of the costs imposed by, and the benefits obtained from, our rules. Whenever we engage in rulemaking and are required to consider or determine whether an action is necessary or appropriate in the public interest, section 202(c) of the Advisers Act requires the Commission to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and

capital formation. The following analysis considers, in detail, the potential economic effects that may result from this rulemaking, including the benefits and costs to market participants as well as the broader implications of the proposed rules for efficiency, competition, and capital formation.

Where possible, the Commission quantifies the likely economic effects of its proposed amendments and rules. However, the Commission is unable to quantify certain economic effects because it lacks the information necessary to provide estimates or ranges of costs. Further, in some cases, quantification would require numerous assumptions to forecast how investment advisers and other affected parties would respond to the proposed amendments and rules, and how those responses would in turn affect the broader markets in which they operate. In addition, many factors determining the economic effects of the proposed amendments and rules would be firm-specific and thus inherently difficult to quantify, such that, even if it were possible to calculate a range of potential quantitative estimates, that range would be so wide as to not be informative about the magnitude of the benefits or costs associated with the proposed rules. Many parts of the discussion below are, therefore, qualitative in nature. As described more fully below, the Commission is providing a qualitative assessment and, where feasible, a quantified estimate of the economic effects.

### B. Economic Baseline

The economic baseline against which we evaluate and measure the economic effects of the proposed rules, including its potential effects on efficiency, competition, and capital formation, is the state of the world in the absence of the proposed rules. We consider the current business practices and disclosure practices of private fund advisers, as well as the current regulation and the forms of external monitoring and investor protections that are currently in place. In addition, in considering the current business and disclosure practices, we consider the usefulness of the information that investment advisers provide to investors about the private funds in which those investors invest, including information that may be helpful for deciding whether to invest (or remain invested) in the fund, monitoring an investment in the fund (in relation to fund documents and in relation to other funds), and other purposes. We further consider the effectiveness of the

disclosures in providing useful information to the investor. For example, fund disclosures can have direct effects on investors by affecting their ability to assess costs and returns and to identify the funds that align with their investment preferences and objectives. Disclosures can also help investors monitor their private fund advisers' conduct, depending in part on the extent to which private funds lack governance mechanisms that would otherwise help check adviser conduct. Disclosures can therefore influence the matches between investor choices of private funds and preferences over private fund terms, investment strategies, and investment outcomes, with more effective disclosures resulting in improved matches.

### 1. Industry Statistics and Affected Parties

The proposed quarterly statement, audit, and adviser-led secondary rules would apply to all SEC registered investment advisers ("RIAs") with private fund clients.<sup>216</sup> Proposed amendments to the books and records rule would also impose corresponding recordkeeping obligations on these advisers.<sup>217</sup> The proposed performance requirements of the quarterly statement rule would vary according to whether the RIA determines the fund is a liquid fund, such as a hedge fund, or an illiquid fund, such as a private equity fund.<sup>218</sup> According to Form ADV data, there are 5,139 such RIAs with private fund clients.

The proposed prohibited activity and preferential treatment rules would apply to all advisers to private funds, regardless of whether the advisers are registered with or reporting as exempt reporting advisers ("ERAs") to the Commission or one or more state securities commissioners or are otherwise not required to register. Proposed amendments to the books and records rule would also impose corresponding recordkeeping obligations on private fund advisers if they are registered with the Commission.<sup>219</sup> Based on Form ADV data, this would include approximately

<sup>216</sup> See proposed rules 206(4)–10, 211(h)(1)–2, 211(h)(2)–2. As discussed above, the proposed rules that pertain to registered investment advisers apply to all investment advisers registered, or required to be registered, with the Commission. See *supra* section II.

<sup>217</sup> See proposed rules 204–2(a)(20), (21), (22), and (23).

<sup>218</sup> See proposed rules 211(h)(1)–2(d).

<sup>219</sup> See proposed rule 204–2(a)(7)(v) (imposing recordkeeping requirements for notices required under the proposed preferential treatment rule).

12,500 advisers to private funds, across RIAs and ERAs.<sup>220</sup>

The proposed amendments to the compliance rule would affect all RIAs, regardless of whether they have private fund clients. According to Form ADV data, there are 15,283 RIAs, across both those who do and do not have private fund clients.

The parties affected by these various proposed rules would include the private fund advisers, advisers to other client types (with respect to the proposed amendments to the compliance rule), private funds, private fund investors, certain other pooled investment vehicles and clients advised by private fund advisers and their related persons, and others to whom those affected parties would turn for assistance in responding to the proposed rules. Private fund investors are generally institutional investors (including, for example, retirement plans, trusts, endowments, sovereign wealth funds, and insurance companies), as well as high net worth individuals. In addition, the parties affected by these various proposed rules could include private fund portfolio investments, such as portfolio companies. For example, certain types

of fees, such as accelerated payment fees, would no longer be able to be charged to those portfolio companies.

The relationships between the affected parties are governed in part by current rules under the Advisers Act, as discussed in Section V.B.3. In addition, relationships between funds and investors generally depend on fund governance.<sup>221</sup> Private funds typically lack fully independent governance mechanisms, such as an independent board of directors or LPAC with direct access to fund information, that would help monitor and govern private fund adviser conduct and check possible overreaching. Although some private funds may have LPACs or boards of directors, these types of bodies may not have the necessary independence, authority, or accountability to oversee and consent to these conflicts or other harmful practices as they may not have sufficient access, information, or authority to perform a broad oversight role. Moreover, the interests of one or more private fund investors may not represent the interests of, or may otherwise conflict with the interests of, other investors in the private fund due to business or personal relationships or other private fund investments, among

other factors. To the extent investors are afforded governance or similar rights, such as LPAC representation, certain fund agreements permit such investors to exercise their rights in a manner that places their interests ahead of the private fund or the investors as a whole. For example, certain fund agreements state that, subject to applicable law, LPAC members owe no duties to the private fund or to any of the other investors in the private fund and are not obligated to act in the interests of the private fund or the other investors as a whole.<sup>222</sup>

Based on Form ADV filing data between October 1, 2020, and September 30, 2021, 5,139 RIAs and 4,900 ERAs reported that they are advisers to private funds.<sup>223</sup> Based on Form ADV data, hedge funds and private equity funds are the most frequently reported private funds among RIAs, followed by real estate and venture capital funds, as shown. In comparison to RIAs, ERAs have fewer assets under management and are more frequently venture capital (VC) funds, followed by private equity funds and hedge funds, with real estate funds more uncommon.

#### PRIVATE FUNDS REPORTED

	Registered investment advisers			Exempt reporting advisers		
	Private funds	Feeder funds	Gross assets (billions)	Private funds	Feeder funds	Gross assets (billions)
Any private funds .....	44,378	12,789	17,470.7	23,940	2,606	5,014.2
Hedge funds .....	11,508	6,731	8,409.1	2,007	1,318	1,980.9
Private equity funds .....	18,820	3,803	5,086.0	6,104	645	1,457.3
Real estate funds .....	4,174	963	804.2	876	187	119.3
Venture capital funds .....	2,065	163	290.4	13,860	285	996.3
Securitized asset funds .....	2,273	81	864.0	96	.....	48.4
Liquidity funds .....	86	7	328.8	11	.....	133.4
Other private funds .....	5,452	1,048	1,688.1	986	171	278.6

\* Source: Form ADV submissions filed between October 1st, 2020 and Sep 30th, 2021. Funds that are listed by both registered investment advisers and SEC-exempt reporting advisers are counted under both categories separately. Gross assets include uncalled capital commitments on Form ADV.

<sup>220</sup> See *infra* footnote 416 (with accompanying text).

<sup>221</sup> See e.g., Lucian Bebchuk, Alma Cohen, and Scott Hirst, The Agency Problems of Institutional Investors, *Journal of Economic Perspectives* (2017). See also John Morley, The Separation of Funds and

Managers: A Theory of Investment Fund Structure and Regulation, 123 *Yale Law Journal* 1231–1287 (2014); Paul G. Mahoney, Manager-Investor Conflicts in Mutual Funds, 18 *Journal of Economic Perspectives* 161–182 (2004).

<sup>222</sup> We observe that LPACs tend to be limited in their ability to receive disclosures about, oversee, or provide approval or consent for addition, private funds also do not have comprehensive mechanisms for such governance by fund investors.

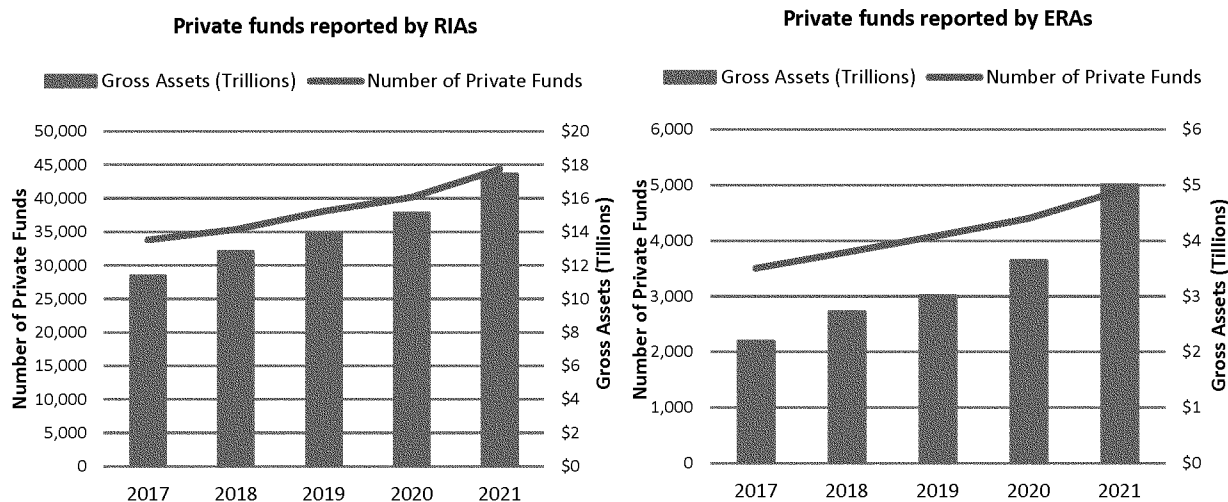
<sup>223</sup> Form ADV Item 5.F.2 and Item 12.A.



Also based on Form ADV data, the market for private fund investing has grown dramatically over the past five years. For example, the assets under management of private equity funds reported by RIAs on Form ADV during this period grew from \$2.6 trillion to \$5.1 trillion, or by 96 percent. The assets under management of hedge

funds reported by RIAs grew from \$6.1 trillion to \$8.4 trillion, or by 38 percent.<sup>224</sup> The assets under management of all private funds reported by RIAs grew by fifty-five percent over the past five years from \$11 trillion to over \$17 trillion,<sup>225</sup> while the number of private funds reported by RIAs grew by thirty-one percent from

33.8 thousand to 44.4 thousand. The assets under management of all private funds reported by ERAs grew by one hundred fifty percent over the past five years from \$2 trillion to over \$5 trillion, while the number of private funds reported by ERAs grew by forty percent from 3.5 thousand to 4.9 thousand, as shown in the figure below.<sup>226</sup>



## 2. Sales Practices, Compensation Arrangements, and Other Business Practices of Private Fund Advisers

Advisers have a fiduciary duty to clients, including private fund clients, that is comprised of a duty of care and a duty of loyalty enforceable under the antifraud provision of Section 206.<sup>227</sup> The duty of care includes, among other things: (i) The duty to provide advice that is in the best interest of the client, (ii) the duty to seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades, and (iii) the duty to provide advice and monitoring over the course of the relationship.<sup>228</sup> The duty of loyalty requires that an adviser not subordinate its client's interests to its own.<sup>229</sup> Private fund advisers are also prohibited from engaging in fraud under the general antifraud and anti-manipulation provisions of the Federal securities laws, including Section 10(b) of the Exchange Act (and rule 10b-5 thereunder) and Section 17(a) of the Securities Act.

Private fund advisers are also subject to rule 206(4)–8 under the Advisers Act, which prohibits investment advisers to pooled investment vehicles, which include private funds, from (1) making any untrue statement of a material fact or omitting to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or (2) otherwise engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle. There are no particularized requirements, however, that deal with many of the revised requirements in this proposal. For example, there is no regulation requiring an adviser to disclose multiple different measures of performance to its investors, to refrain from borrowing from a private fund client, to obtain a

fairness opinion from an independent opinion provider when leading secondary transactions, or to disclose preferential treatment of certain investors to other investors.

In the absence of more particularized requirements, we have observed business practices of private fund advisers that enrich advisers without providing any benefit of services to the private fund and its underlying investors or create incentives for an adviser to place its own interests ahead of the private fund's interests. For example, as discussed above, some private fund advisers have entered into arrangements with a fund's portfolio investments to provide services which permit the adviser to accelerate the unpaid portion of fees upon the occurrence of certain triggering events, even though the adviser will never provide the contracted-for services.<sup>230</sup> These fees enrich advisers without providing the benefit of any services to

<sup>224</sup> The number of private equity funds reported by RIAs on Form ADV during this period grew from 12,819 to 18,820, or by 47 percent. The number of hedge funds reported by RIAs grew from 11,114 to 11,508, or by 3.5 percent.

<sup>225</sup> As of September 30, 2021. As noted above, the assets under management of registered private fund

advisers has since continued to grow, exceeding \$18 trillion as of November 31, 2021. See *supra* footnote 6.

<sup>226</sup> See Form ADV data.

<sup>227</sup> See 2019 IA Fiduciary Duty Interpretation, see also *supra* footnote 140. Investment advisers also have antifraud liability with respect to prospective

clients under section 206 of the Advisers Act, which, among other aspects, applies to transactions, practices, or courses of business which operate as a fraud or deceit upon prospective clients.

<sup>228</sup> *Id.*

<sup>229</sup> *Id.*

<sup>230</sup> See *supra* section II.D.1.

the private fund and its underlying investors.

We have also seen a trend in the industry where certain advisers charge a private fund for fees and expenses incurred by the adviser in connection with the establishment and ongoing operations of its advisory business.<sup>231</sup> We recognize, for example, that certain private fund advisers, most notably for hedge funds that utilize a “pass-through” expense model, employ an arrangement where the private fund pays for most, if not all, of the adviser’s expenses, and that in exchange, the adviser does not charge a management, advisory, or similar fee (but does charge an incentive or performance fee on net returns of the private fund).<sup>232</sup> Under these or other similar circumstances in which advisers charge private funds fees associated with the adviser’s cost of being an investment adviser, investor returns are reduced by the amount of the adviser’s overhead and operating costs.

Some investors may not anticipate the performance implications of these disclosed costs, or may avoid investments out of concern that such costs may be present. For those investors, this could lead to a mismatch between investor choices of private funds and their preferences over private fund terms, investment strategies, and investment outcomes, relative to what would occur in the absence of such unexpected or uncertain costs.

In addition, our staff has observed instances in which advisers have entered into agreements that reduce the amount of clawbacks by taxes paid, or deemed to be paid, by the adviser or its owners,<sup>233</sup> and instances in which limited partnership agreements limit or eliminate liability for adviser misconduct.<sup>234</sup> While these agreements are negotiated between fund advisers and investors, as discussed above advisers often have discretion over the timing of fund payments, and so may have greater control over risks of clawbacks than anticipated by investors.<sup>235</sup> As such, reducing the amount of clawbacks by actual, potential, or hypothetical taxes therefore passes an unnecessary and avoidable cost to investors. This cost denies investors the restoration of distributions or allocations to the fund that they

would have been entitled to receive in the absence of an excess of performance-based compensation paid to the adviser or a related person. These clawback terms can therefore reduce the alignment between the fund adviser’s and investors’ interests. Lastly, the elimination of liability for adviser misconduct could reduce or eliminate investor recoveries of losses in connection with misconduct, which could make such misconduct more likely to occur.

We have also observed some cases where private fund advisers have directly or indirectly (including through a related person) borrowed from private fund clients.<sup>236</sup> This practice carries a risk of investor harm because the fund client may be prevented from using borrowed assets to further the fund’s investment strategy, and so the fund may fail to maximize the investor’s returns. This risk is relatively higher for those investors that are not able to negotiate or directly discuss the terms of the borrowing with the adviser, and for those funds that do not have an independent board of directors or LPAC to review and consider such transactions.<sup>237</sup>

The staff also has observed harm to investors from disparate treatment of investors in a fund. For example, our staff has observed scenarios where an adviser grants certain private fund investors and/or investments in substantially similar pools of assets with better liquidity terms than other investors.<sup>238</sup> These preferential liquidity terms can disadvantage other fund investors or investors in a substantially similar pool of assets if, for instance, the preferred investor is able to exit the private fund or pool of assets at a more favorable time.<sup>239</sup> Similarly, private fund advisers, in some cases, disclose information about a private fund’s investments to certain, but not all, investors in a private fund, which can result in profits or avoidance of losses among those who were privy to the information beforehand at the expense of those kept in the dark.<sup>240</sup> Currently, many investors need to engage in their own research regarding what terms may be obtained from advisers, as well as whether other investors are likely to be obtaining better terms than those they are initially offered.

The staff also has observed harm to investors when advisers lead multiple private funds and other clients advised

by the adviser or its related persons to invest in a portfolio investment.<sup>241</sup> In those instances, the staff observed advisers allocating fees and expenses among those clients on a non pro rata basis, resulting in some fund clients (and investors in those funds) being charged relatively higher fees and expenses than other clients.<sup>242</sup> Advisers may make these decisions in order to avoid charging some portion of fees and expenses to funds with insufficient resources to bear its pro rata share of expenses related to a portfolio investment (whether due to insufficient reserves, the inability to call capital to cover such expenses, or otherwise) or funds in which the adviser has greater interests.

We understand that it can be difficult for investors to have full transparency into the scenarios described above relating to conflicts of interest. For example, the Commission has pursued enforcement actions against private fund advisers where the adviser failed to inform investors about benefits that the advisers obtained from accelerated monitoring fees.<sup>243</sup> Further, the Commission also has pursued enforcement actions against private fund advisers in other circumstances in which investors were not informed of relevant conflicts of interest.<sup>244</sup>

While our staff has observed that some advisers have begun to more fully disclose sales practices, conflicts of interests, and compensation schemes to investors and the practices that are associated with them, we believe that it may be hard even for sophisticated investors with full and fair disclosure, to understand the future implications of terms and practices related to these practices at the time of investment and during the investment. Further, some investors may find it relatively difficult to negotiate agreements that would fully protect them from bearing unexpected portions of fees and expenses or from other decreases in the value of investments associated with the above-described practices. For example, some forms of negotiation may occur through repeat-dealing that may not be available to some smaller private fund investors.<sup>245</sup> For any investors affected

<sup>241</sup> See *supra* section II.D.5.

<sup>242</sup> *Id.*

<sup>243</sup> See *supra* footnote 10 (with accompanying text).

<sup>244</sup> *Id.*

<sup>245</sup> A study of leveraged buyout transactions from 1990–2012 found that accelerated monitoring fees had been charged in 28 percent of leveraged buyout transactions, representing 15 percent of total fees charged in those transactions. See Ludovic Phalippou, Christian Rauch, and Marc Ueber,

Continued

<sup>231</sup> See *supra* section II.D.2.

<sup>232</sup> See, e.g., Eli Hoffmann, *Welcome To Hedge Funds’ Stunning Pass-Through Fees*, *Seeking Alpha* (Jan. 24, 2017), available at <https://seekingalpha.com/article/4038915-welcome-to-hedge-funds-stunning-pass-through-fees>.

<sup>233</sup> See *supra* section II.D.3.

<sup>234</sup> See *supra* section II.D.4.

<sup>235</sup> See *supra* section II.D.3.

<sup>236</sup> See *supra* section II.D.6.

<sup>237</sup> *Id.*

<sup>238</sup> See *supra* section II.E.

<sup>239</sup> *Id.*

<sup>240</sup> *Id.*

by these issues, including potentially sophisticated investors, there may be mismatches between investor choices of private funds and preferences over private fund terms, investment strategies, and investment outcomes, relative to what would occur in the absence of such unexpected or uncertain costs.

Our staff has also observed that investors are generally not provided with detailed information about these preferential terms.<sup>246</sup> This lack of transparency prevents investors from understanding the scope or magnitude of preferential terms granted, and as a result, may prevent such investors from requesting additional information on these terms or other benefits that certain investors, including the adviser's related persons or large investors, receive. In this case, these investors may simply be unaware of the types of contractual terms that could be negotiated. To the extent this lack of transparency affects investor choices of where to allocate their capital, it can result in mismatches between investor choices of private funds and their preferences over private fund terms, investment strategies, and investment outcomes.

### 3. Private Fund Adviser Fee, Expense, and Performance Disclosure Practices

Current rules under the Advisers Act do not require advisers to provide quarterly statements detailing fees and expenses (including fees and expenses paid to the adviser and its related persons by portfolio investments) to private fund clients or to fund investors. The custody rule does, however, generally require advisers whose private fund clients are not undergoing a financial statement audit to have a reasonable basis for believing that the qualified custodians that maintain private fund client assets provide quarterly account statements to the fund's limited partners. Those account statements may contain some of this information, though in our experience adviser fees and expenses typically are not presented with the level of specificity the proposed quarterly statement rule would require. In addition, Form ADV Part 2A (the "brochure") requires certain information about an adviser's fees and compensation. For example, Part 2A, Item 6 of Form ADV requires an adviser to disclose in its brochure whether the adviser accepts performance-based fees, whether the adviser manages both accounts that are charged a

performance-based fee and accounts that are charged another type of fee, and any potential conflicts. Although the brochure is not required to be delivered to investors in a private fund, the information on Form ADV is available to the public, including private fund investors, through the Commission's Investment Adviser Public Disclosure ("IAPD") website.<sup>247</sup> We understand that many prospective fund investors obtain the brochure and other Form ADV data through the IAPD public website.

Similarly, there currently are no requirements under current Advisers Act rules for advisers to provide investors with a quarterly statement detailing private fund performance. Although our recently adopted marketing rule contains requirements that pertain to displaying performance information and providing information about specific investments in adviser advertisements, these requirements do not *compel* the adviser to provide performance information to all private fund clients or investors. Rather, the requirements apply when an adviser *chooses* to include performance or address specific investments within an advertisement.<sup>248</sup>

Within this framework, advisers have exercised discretion in responding to the needs of private fund investors for periodic statements regarding fees, expenses, and performance or similar information on their current investments.<sup>249</sup> Broadly, current investors in a fund rely on this information in determining whether to invest in subsequent funds and investment opportunities with the same adviser, or to pursue alternative investment opportunities. When fund advisers raise multiple funds sequentially, they often consider current investors to also be prospective investors in their subsequent funds, and

so may make disclosures to motivate future capital commitments. This has led to the development of diverse approaches to the disclosure of fees, expenses, and performance.<sup>250</sup> A private fund adviser may agree, contractually or otherwise, to provide disclosures to a fund investor, and on the details of these disclosures, at the time of the investment or subsequently. A private fund adviser also may provide such information in the absence of an agreement. The format, scope and reporting intervals of these disclosures vary across advisers and private funds.<sup>251</sup> Some disclosures provide limited information while others are more detailed and complex. Investors may, as a result, find it difficult to assess and compare alternative fund investments, which can make it harder to allocate capital among competing fund investments or among private funds and other potential investments. Limitations in required disclosures by advisers may therefore result in mismatches between investor choices of private funds and their preferences over private fund terms, investment strategies, and investment outcomes.

While a variety of practices are used, as the market for private fund investing has grown, some patterns have emerged. We understand that most private fund advisers currently provide current investors with quarterly reporting, and many private fund advisers contractually agree to provide fee, expense, and performance reporting to current investors.<sup>252</sup> Further, advisers typically provide information to existing investors about private fund fees and expenses in periodic financial statements, schedules, and other reports under the terms of the fund documents.<sup>253</sup>

However, reports that are provided to investors may report only aggregated expenses, or may not provide detailed information about the calculation and implementation of any negotiated rebates, credits, or offsets.<sup>254</sup> Investors may use the information that they receive about their fund investments to monitor the expenses and performance

<sup>247</sup> Advisers generally are required to update disclosures on Form ADV on both an annual basis, or when information in the brochure becomes materially inaccurate. Additionally, although advisers are not required to deliver the Form ADV Part 2A brochure to private fund investors, many private fund advisers choose to provide the brochure to investors as a best practice.

<sup>248</sup> While the marketing rule became effective as of May 4, 2021, the Commission has set a compliance date of November 4, 2022 (eighteen months following the effective date) to give advisers sufficient time to comply with the provisions of the amended rules. As a result, while some advisers may have begun to comply with the marketing rule, some advisers may not currently be in compliance with the marketing rule. As discussed above, the marketing rule and its specific protections would generally not apply in the context of a quarterly statement. See *supra* footnote 62.

<sup>249</sup> See *supra* section II.B.1 (regarding the role of governance mechanisms in the relationship between the fund and the investors).

<sup>250</sup> See, e.g., William W Clayton, Public Investors, Private Funds, and State Law, 72 *Baylor Law Review* 294 (BYU Law Research Paper No. 20–13) (July 2020), available at: <https://ssrn.com/abstract=3573773>.

<sup>251</sup> One observer of the variation in reporting practices across funds has suggested the use of a standardized template for this purpose. See, e.g., Reporting Template, The Institutional Limited Partners Association, available at <https://ilpa.org/reporting-template/>. ILPA is a trade group for investors in private funds.

<sup>252</sup> See *supra* section II.A.1, II.A.2.

<sup>253</sup> *Id.*

<sup>254</sup> See *supra* section II.A.

Private Equity Portfolio Company Fees, 129 *Journal of Financial Economics*, 559–585 (2018).

<sup>246</sup> See *supra* section II.E.

from those investments. Their ability to measure and assess the impact of fees and expenses on their investment returns depends on whether, and to what extent, they are able to receive detailed disclosures regarding those fees and expense and regarding fund performance. Some investors currently do not receive such detailed disclosures, and this reduces their ability to monitor the performance of their existing fund investment or to compare it with other prospective investments.

In other cases, adviser reliance on exemptions from specific regulatory burdens for other regulators can lead advisers to make certain quarterly disclosures. For example, while we believe that many advisers to hedge funds subject to the jurisdiction of the U.S. Commodity Futures Trading Commission (“CFTC”) rely on an exemption provided in CFTC Regulation § 4.13 from the requirement to register with CFTC as a “commodity pool operator,” some may rely on other CFTC exemptions, exclusions or relief. Specifically, we believe that some advisers registered with the CFTC may operate with respect to a fund in reliance on CFTC Regulation § 4.7, which provides certain disclosure, recordkeeping and reporting relief and to the extent that the adviser does so, the adviser would be required to, no less frequently than quarterly, prepare and distribute to pool participants statements that present, among other things, the net asset value of the exempt pool and the change in net asset value from the end of the previous reporting period.

In addition, information about advisers’ fees and about expenses is often included in advisers’ marketing documents, or included in the fund documents. Many advisers to private equity funds and other funds that would be determined to be illiquid funds under the proposed rule provide prospective investors with access to a virtual data room for the fund, containing the fund’s offering documents (including categories of fees and expenses that may be charged), as well as the adviser’s brochure and other ancillary items, such as case studies.<sup>255</sup>

<sup>255</sup> To the extent that a private fund’s securities are offered pursuant to 17 CFR 230.500 through 230.508 (Regulation D of the Securities Act) and such offering is made to an investor who is not an “accredited investor” as defined therein, that investor must be provided with disclosure documents that generally contain the same type of information required to be provided in offerings under Regulation A of the Securities Act, as well as certain financial statement information. See 17 CFR 230.502(b). However, private funds generally do not offer interests in funds to non-accredited investors.

These advisers meet the contractual and other needs of investors for updated information by updating the documents in the data room. Many advisers to funds that would be considered liquid funds under the proposed rule, such as hedge funds, tend not to use data rooms. They instead take the approach of sending email or using other methods to convey updated information to investors. For instance, prior to closing on a prospective investor’s investment, some advisers send out pre-closing email messages containing updated versions of these and other documents. While these data rooms and email communications are therefore limited in their use for disclosing ongoing fees and expenses over the life of the fund, prospective investors at the start of the life of a fund, or at or before the time of their investment, may use this information in conducting due diligence, in deciding whether to seek to negotiate the terms of investment, and ultimately in deciding whether to invest in the adviser’s fund.

The adviser’s and related persons’ rights to compensation, which are set forth in fund documents, vary across fund types and advisers and can be difficult to quantify at the time of the initial investment. For example, advisers of private equity funds generally receive a management fee (compensating the adviser for bearing the costs relating to the operation of the fund and its portfolio investment) and performance-based compensation (further incentivizing advisers to maximize investor value).<sup>256</sup>

Performance-based compensation arrangements in private equity funds typically require that investors recoup capital contributions plus a minimum annual return (called the “hurdle rate” or “preferred return”), but these arrangements can vary according to the waterfall arrangement used, meaning that distribution entitlements between the adviser (or its related persons) and the private fund investors can depend on whether the proceeds are distributed on a whole-fund (known as European-style) basis or a deal-by-deal (known as American-style) basis.<sup>257</sup> In the whole-fund (European) case, the fund typically allocates all investment proceeds to the investors until they recoup 100% of their capital contributions attributable to both realized and unrealized

<sup>256</sup> See *supra* section II.A.1.

<sup>257</sup> See, e.g., David Snow, Private Equity: A Brief Overview, *PEI Media* (2007), available at [https://www.law.du.edu/documents/registrars/adv-assign/Yoost\\_PrivateEquity%20Seminar\\_PEI%20Media's%20Private%20Equity%20-%20A%20Brief%20Overview\\_318.pdf](https://www.law.du.edu/documents/registrars/adv-assign/Yoost_PrivateEquity%20Seminar_PEI%20Media's%20Private%20Equity%20-%20A%20Brief%20Overview_318.pdf). See also *supra* footnote 166.

investments plus their preferred return, at which point fund advisers typically begin to receive performance-based compensation.<sup>258</sup> In the deal-by-deal (American) case (or modified versions thereof), it is common for investment proceeds from each portfolio investment to be allocated 100% to investors until investors recoup their capital contributions attributable to that specific investment, any losses from other realized investments, and their applicable preferred return, and then fund advisers can begin to receive performance-based compensation from that investment.<sup>259</sup> Under the deal-by-deal waterfall, advisers can potentially receive performance-based compensation earlier in the life of the fund, as successful investments can deliver advisers performance-based compensation before investors have recouped their entire capital contributions to the fund.<sup>260</sup>

Management fee compensation figures and performance-based compensation figures are not widely disclosed or reported,<sup>261</sup> but the sizes of certain of these fees have been estimated in industry and academic literature. For example, one study estimated that from 2006–2015, performance-based compensation alone for private equity funds averaged \$23 billion per year.<sup>262</sup> Private fund fees increase as assets under management increase, and the private fund industry has grown since 2015, and as a result private equity management fees and performance-based compensation fees may together

<sup>258</sup> *Id.*

<sup>259</sup> *Id.*

<sup>260</sup> Waterfalls (especially deal-by-deal waterfalls) typically have clawback arrangements to ensure that advisers do not retain carried interest unless investors recoup their entire capital contributions on the whole fund, plus a preferred return. The result is that total distributions to investors and advisers under the two waterfalls can be equal (but may not always be), conditional on correct implementation of clawback provisions. In that case, the key difference in the two arrangements is that deal-by-deal waterfalls result in fund advisers potentially receiving their performance-based compensation faster. However, some deal-by-deal waterfalls may also require fund advisers to escrow their performance-based compensation until investors receive their total capital contributions to the fund plus their preferred return on the total capital contributions. These escrow policies can help secure funds that may need to be available in the event of a clawback. *Id.*

<sup>261</sup> Ludovic Phalipoou, An Inconvenient Fact: Private Equity Returns & The Billionaire Factory *University of Oxford, Said Business School*, (Working Paper), (June 10, 2020), available at <https://ssrn.com/abstract=3623820> or <http://dx.doi.org/10.2139/ssrn.3623820>.

<sup>262</sup> *Id.* See also Division of Investment Management: Analytics Office, Private Funds Statistics Report: Fourth Calendar Quarter 2015, at 5 (July 22, 2016), available at <https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2015-q4.pdf>.

currently total over \$100 billion dollars in fees per year.<sup>263</sup> Private equity represents \$4.2 trillion of the \$11.5 trillion dollars in net assets under management by private funds,<sup>264</sup> and so total fees across the private fund industry may be over \$200 billion dollars in fees per year.<sup>265</sup>

In addition, advisers or their related persons may receive a monitoring fee for consulting services targeted to a specific asset or company in the fund portfolio.<sup>266</sup> Whether they ultimately retain the monitoring fee depends, in part, on whether the fund's governing documents require the adviser to offset portfolio investment compensation

<sup>263</sup> Private equity management fees are currently estimated to typically be 1.76 percent and performance-based compensation is currently estimated to typically be 20.3 percent of private equity fund profits. See, e.g., Ashley DeLuce and Pete Keliuotis, *How to Navigate Private Equity Fees and Terms*, *Callan's Research Café* (October 7, 2020), available at <https://www.callan.com/uploads/2020/12/2841fa9a3ea9dd4ddd6f4daefe1cec4/callan-institute-private-equity-fees-terms-study-webinar.pdf>; Private equity net assets under management as of the fourth quarter of 2020 were approximately \$4.2 trillion. Division of Investment Management: Analytics Office, *Private Funds Statistics Report: Fourth Calendar Quarter 2020 at 5* (August 4, 2021), available at <https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2020-q4.pdf>. Total fees may be estimated by multiplying management fee percentages by net assets under management, and by multiplying performance-based compensation percentages by net assets under management and again by an estimate of private equity annual returns, which may conservatively be assumed to be approximately 10 percent. See, e.g., Michael Cembalest, *Food Fight: An Update on Private Equity Performance vs. Public Equity Markets*, *J.P. Morgan Asset and Wealth Management* (June 28, 2021), available at <https://privatebank.jpmorgan.com/content/dam/jpm-wm-aem/global/pb/en/insights/eye-on-the-market/private-equity-food-fight.pdf>.

<sup>264</sup> See Division of Investment Management: Analytics Office, *Private Funds Statistics Report: Fourth Calendar Quarter 2020 at 5* (August 4, 2021), available at <https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2020-q4.pdf>.

<sup>265</sup> For example, hedge fund management fees are currently estimated to typically be 1.4 percent per year and performance-based compensation is currently estimated to typically be 16.4 percent of hedge fund profits, approximately consistent with private equity fees. See, e.g., Leslie Picker, *Two and Twenty is Long Dead: Hedge Fund Fees Fall Further Below Onetime Industry Standard*, CNBC, available at <https://www.cnbc.com/2021/06/28/two-and-twenty-is-long-dead-hedge-fund-fees-fall-further-below-one-time-industry-standard.html> (citing HRF Microstructure Hedge Fund Industry Report Year End 2020). Hedge funds as of the fourth quarter of 2020 were represented another approximately \$4.7 trillion in net assets under management. See Division of Investment Management: Analytics Office, *Private Funds Statistics Report: Fourth Calendar Quarter 2020 at 5* (August 4, 2021), available at <https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2020-q4.pdf>.

<sup>266</sup> See e.g., Ludovic Phalippou, Christian Rauch, and Marc Ueber, *Private Equity Portfolio Company Fees*, 129 (3) *Journal of Financial Economics*, 559–585 (2018).

against other revenue streams or otherwise provide a rebate to the fund (and so indirectly to the fund investors).<sup>267</sup> There can be substantial variation in the fees private fund advisers charge for similar services and performances.<sup>268</sup> Ultimately, the fund (and indirectly the investors) bears the costs relating to the operation of the fund and its portfolio investments.<sup>269</sup>

Regarding performance disclosure, advisers typically provide information about fund performance to investors through the account statements, transaction reports, and other reports. Some advisers, primarily private equity fund advisers, also disclose information about past performance of their funds in the private placement memoranda that they provide to prospective investors.

Many standardized industry methods have emerged that private funds rely on to report returns and performance.<sup>270</sup> However, each of these standardized industry methods has a variety of benefits and drawbacks, including differences in the information they are able to capture and their susceptibility to manipulation by fund advisers.

For private equity and other funds that would be determined to be illiquid under the proposed rules, standardized industry methods for measuring performance must contend with the complexity of the timing of illiquid investments. One approach that has emerged for computing returns for private equity and other fund that would be determined to be illiquid funds is the internal rate of return ("IRR").<sup>271</sup> As discussed above, an

<sup>267</sup> See *supra* section II.A.1. There may be certain economic arrangements where only certain investors to the fund receive credits from rebates.

<sup>268</sup> See e.g., Julianne Begenau and Emil Siriwardane, *How Do Private Equity Fees Vary Across Public Pensions?*, 20–073 *Harvard Business School* (Working Paper) (January 2020) (Revised February 2021) (concluding that a sample of public pension funds investing in a sample of private equity funds would have received an average of an additional \$8.50 per \$100 invested had they received the best observed fees in the sample); Tarun Ramadorai and Michael Streatfield, *Money for Nothing? Understanding Variation in Reported Hedge Fund Fees*, *Paris December 2012 Finance Meeting EUROFIDAI-AFFI Paper*, (March 28, 2011) (finding that a sample of hedge fund advisers, management fees ranging from less than .5 percent to over 2 percent and finding incentive fees ranging from less than 5 percent to over 20 percent, with no detectable difference in performance by funds with different management fees and only modest evidence of higher incentive fees yielding higher returns), available at <https://ssrn.com/abstract=1798628> or <http://dx.doi.org/10.2139/ssrn.1798628>.

<sup>269</sup> See *supra* section II.A.1, II.D.1.

<sup>270</sup> As discussed above, certain factors are currently used for determining how certain types of private funds should report performance under U.S. GAAP. See *supra* footnote 71 (with accompanying text).

<sup>271</sup> See *supra* section II.A.2.b.

important benefit of IRR that drives its use is that IRR can reflect the timing of cash flows more accurately than other performance measures.<sup>272</sup> All else equal, a fund that delivers returns to its investors faster will have a higher IRR.

However, current use of IRR to measure returns has a number of drawbacks, including an upward bias in the IRR that comes from a fund's use of leverage, assumptions about the reinvestment of proceeds, and a large effect on measured IRR from cash flows that occur early in the life of the pool. For example, as discussed above, some private equity funds borrow extensively at the fund level.<sup>273</sup> This can cause IRRs to be biased upwards. Since IRRs are based in part on the length of time between the fund calling up investor capital and the fund distributing profits, private equity funds can delay capital call-ups by first borrowing from fund-level subscription facilities to finance investments.<sup>274</sup> This practice has been used by private equity funds to artificially boost reported IRRs, but investors must pay the interest on the debt used and so can potentially suffer lower total returns.<sup>275</sup>

As for reinvestment assumptions, the IRR as a performance measure assumes that cash proceeds have been reinvested at the IRR over the entire investment period. For example, if a private equity or other fund determined to be illiquid reports a 50% IRR but has exited an investment and made a distribution to investors early in its life, the IRR assumes that the investors were able to reinvest their distribution again at a 50% annual return for the remainder of the life of the fund.<sup>276</sup>

Although IRR remains one of the leading standardized methods of reporting returns at present, these and other drawbacks make IRR difficult as a singular return measure, especially for investors who likely may not understand the limitations of the IRR metric, and the differences between IRR and total return metrics used for public equity or registered investment funds.

Several other measures have emerged for measuring the performance of

<sup>272</sup> *Id.*

<sup>273</sup> *Id.*

<sup>274</sup> *Id.*

<sup>275</sup> See e.g., James F. Albertus & Matthew Denes, *Distorting Private Equity Performance: The Rise of Fund Debt*, Frank Hawkins Kenan Institute of Private Enterprise Report (June 2019), available at [https://www.kenaninstitute.unc.edu/wp-content/uploads/2019/07/DistortingPrivateEquityPerformance\\_07192019.pdf](https://www.kenaninstitute.unc.edu/wp-content/uploads/2019/07/DistortingPrivateEquityPerformance_07192019.pdf).

<sup>276</sup> See e.g., Oliver Gottschalg and Ludovic Phalippou, *The Truth About Private Equity Performance*, *Harvard Business Review* (Dec. 2007), available at <https://hbr.org/2007/12/the-truth-about-private-equity-performance>.

private equity and other funds that would be determined to be illiquid under the proposal. These measures compensate for some of the shortcomings of IRR at the cost of their own drawbacks. Multiple of invested capital (MOIC), used by private equity funds, is the sum of the net asset value of the investment plus all the distributions received divided by the total amount paid in. MOIC is simple to understand in that it is the ratio of value received divided by money invested, but has a key drawback that, unlike IRR, MOIC does not take into account the time value of money. Another measure, Public Market Equivalent (“PME”), also used by private equity and other funds determined to be illiquid, is sometimes used to compare the performance of a fund with the performance of an index.<sup>277</sup> The measure is an estimate of the value of fund cash flows relative to the value of a public market index. Relative to a given benchmark, differences in PME can indicate differences in the performance of different private fund investments. However, the computation of the PME for a fund requires the availability of information about fund cash flows including their timing and magnitude.

Regardless of the performance measure applied, another fundamental difficulty in reporting the performance of funds determined to be illiquid is accounting for differences in realized and unrealized gains. Funds determined to be illiquid funds generally pursue longer-term investments, and reporting of performance before the fund’s exit requires estimating the unrealized value of ongoing investments.<sup>278</sup> There are often multiple methods that may be used for valuing an unrealized illiquid investment. As discussed above, the valuations of these unrealized illiquid investments are typically determined by the adviser and, given the lack of readily available market values, can be challenging. Such methods may rely on unobservable models and other inputs.<sup>279</sup> Because advisers are typically evaluated (and, in certain cases, compensated) based on the value of these illiquid investments, unrealized valuations are at risk of being inflated, such that fund performance may be

overstated.<sup>280</sup> Some academic studies have found broadly that private equity performance is overstated, driven in part by inflated accounting of ongoing investments.<sup>281</sup>

Other approaches tend to be used for evaluating the performance of hedge funds and other liquid funds. In particular, a fund’s alpha is its excess return over a benchmark index of comparable risk. A fund’s Sharpe ratio is its excess return above the risk-free market rate divided by the investment’s standard deviation of returns. Many, but not all, hedge funds disclose these and other performance measures, including net returns of the fund. Many hedge fund-level performance metrics can be calculated by investors directly using data on the fund’s historical returns, by either combining with publicly available benchmark index data (in the case of alpha) or by combining with an estimate of the standard deviation of the fund’s returns (in the case of the Sharpe ratio). Despite these detailed methods, public data on hedge fund performance reporting may also be biased, because hedge funds choose whether and when to make their performance results publicly available.<sup>282</sup>

While the Commission believes that many advisers currently select from these varying standardized industry methods in order to prepare and present performance information, the difficulty in measuring and reporting returns on a basis comparable with respect to risk, coupled with the potentially high fees and expenses associated with these funds, can present investors with difficulty in monitoring and selecting their investments. Specifically, without disclosure of detailed performance measures and accounting for the impact of risk, debt, the varying impact of realized and unrealized gains, performances across funds can be highly overstated or otherwise manipulated, and so impossible to compare.<sup>283</sup>

<sup>280</sup> *Id.*

<sup>281</sup> See e.g., Ludovic Phalippou and Oliver Gottschalg, *The Performance of Private Equity Funds*, 22 (4) *The Review of Financial Studies* 1747–1776 (Apr. 2009).

<sup>282</sup> See e.g., Philippe Jorion and Christopher Schwarz, *The Fix Is In: Properly Backing Out Backfill Bias*, 32 (12) *The Society For Financial Studies* 5048–5099 (Dec. 2019); see also Nikolay Gantchev, *The Costs of Shareholder Activism: Evidence From A Sequential Decision Model*, 107 *Journal of Financial Economics* 610–631 (2013).

<sup>283</sup> See, e.g., Ludovic Phalippou and Oliver Gottschalg, *The Performance of Private Equity Funds*, 22 (4) *The Review of Financial Studies*, 1747–1776 (Apr. 2009); Michael Cembalest, *Food Fight: An Update on Private Equity Performance vs. Public Equity Markets*, J.P. Morgan Asset and Wealth Management (June 28, 2021), available at <https://privatebank.jpmorgan.co/content/dam/jpm-wm-aem/global/pb/en/insights/eye-on-the-market/private-equity-food-fight.pdf>.

#### 4. Fund Audits and Fairness Opinions

Currently under the custody rule, some private fund advisers may obtain financial statement audits as an alternative to the requirement of the rule that an RIA with custody of client assets obtain an annual surprise examination from an independent public accountant.<sup>284</sup> This incentivizes registered private fund advisers to have the financial statements of their private fund clients audited. Advisers of funds that obtain these audits, regardless of the type of fund, are thus able to provide fund investors with reasonable assurances of the accuracy and completeness of the fund’s financial statements and, specifically, that the financial statements are free from material misstatements.<sup>285</sup>

Also under the custody rule, an adviser’s choice for a fund to obtain an external financial statement audit (in lieu of a surprise examination) may depend on the benefit of the audit from the adviser’s perspective, including the benefit of any assurances that an audit might provide investors about the reliability of the financial statement. The adviser’s choice also may depend on the cost of the audit, including fees and expenses.

Based on Form ADV data and as shown below, more than 90 percent of the total number of hedge funds and private equity funds that are advised by RIAs currently undergo a financial statement audit, though such audits are not necessarily always by a PCAOB-registered independent public accountant that is subject to regular inspection.<sup>286</sup> Other types of funds

<sup>284</sup> See *supra* section II.B; rule 206(4)–2(b)(4). The staff has stated that, in order to meet the requirements of rule 206(4)–2(b)(4), these financial statements must be prepared in accordance with U.S. GAAP or, for certain non-U.S. funds and non-U.S. advisers, prepared in accordance with other standards, so long as they contain information substantially similar to statements prepared in accordance with U.S. GAAP, with material differences reconciled. See Staff Responses to Questions About the Custody Rule, available at [https://www.sec.gov/divisions/investment/custody\\_faq\\_030510.htm](https://www.sec.gov/divisions/investment/custody_faq_030510.htm).

<sup>285</sup> See, e.g., AS 2301: The Auditor’s Responses to the Risks of Material Misstatement, PCAOB, available at <https://pcaobus.org/oversight/standards/auditing-standards/details/AS2301>; AU–C Section 240: Consideration of Fraud in a Financial Statement Audit, AICPA (2021), available at <https://us.aicpa.org/content/dam/aicpa/research/standards/auditattest/downloadabledocuments/au-c-00240.pdf>.

<sup>286</sup> Rule 206(4)–2(a)(4) requires that an adviser that is registered or required to be registered under Section 203 of the Act with custody of client assets to obtain an annual surprise examination from an independent public accountant. An adviser to a pooled investment vehicle that is subject to an annual financial statement audit by a PCAOB-registered independent public accountant that is

Continued

<sup>277</sup> See e.g., Robert Harris, Tim Jenkinson and Steven Kaplan, *Private Equity Performance: What Do We Know?*, 69 (5) *Journal of Finance* 1851 (Mar. 27, 2014), available at <https://onlinelibrary.wiley.com/doi/full/10.1111/jofi.12154>; Steven Kaplan and Antoinette Schoar, *Private Equity Performance: Returns, Persistence, and Capital Flows*, 60 (5) *Journal of Finance* (Aug. 2005), available at <http://web.mit.edu/aschoar/www/KaplanSchoar2005.pdf>.

<sup>278</sup> See *supra* section II.A.2.b.

<sup>279</sup> *Id.*

advised by RIAs undergo financial statement audits with similarly high

frequency, with the exception of securitized asset funds, of which fewer

than 20 percent are audited according to the recent ADV data.

Fund type	Total funds	Unaudited funds	Unaudited %	Audited %
Hedge Fund .....	11,508	431	3.7	96.3
Liquidity Fund .....	86	10	11.6	88.4
Other Private Fund .....	5,452	545	10.0	90.0
Private Equity Fund .....	18,820	1,167	6.2	93.8
Real Estate Fund .....	4,174	518	12.4	87.6
Securitized Asset Fund .....	2,273	1,931	85.0	15.0
Venture Capital Fund .....	2,065	380	18.4	81.6
Unique Totals .....	44,378	4,982	11.2	88.8

Source: Form ADV, Schedule D, Section 7.B.(1) filed between Oct 1st, 2020 and Sep 30th, 2021.

These audits, while currently valuable to investors, do not obviate the issues with fee, expense, and performance reporting discussed above.<sup>287</sup> First, as shown in the table above, not all funds advised by RIAs currently undergo annual financial statement audits. Second, statements regarding fees, expenses, and performance tend to be more frequent, and thus more timely, than audited annual financial statements. Lastly, more frequent fee, expense, and performance disclosures can include incremental and more granular information that would be useful to investors and that would not typically be included in an annual financial statement.<sup>288</sup>

Regarding fairness opinions, our staff has observed a recent rise in adviser-led secondary transactions where an adviser offers fund investors the option to sell their interests in the private fund or to exchange them for new interests in another vehicle advised by the adviser.<sup>289</sup> We understand that some, but not all, advisers obtain fairness opinions in connection with these transactions that typically address whether the price offered is fair. These fairness opinions provide investors with some third-party assurance as a means to help protect participating investors.

##### 5. Books and Records

The books and records rule includes requirements for recordkeeping to promote, and facilitate internal and external monitoring of, compliance. For example, the books and records rule requires advisers registered or required to be registered under Section 203 of the

Act to make and keep true, accurate and current certain books and records relating to their investment advisory businesses, including advisory business financial and accounting records, and advertising and performance records.<sup>290</sup> Advisers are required to maintain and preserve these records in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the investment adviser.<sup>291</sup>

##### 6. Documentation of Annual Review Under the Compliance Rule

Under the Advisers Act compliance rule, advisers registered or required to be registered under Section 203 of the Act must review no less frequently than annually the adequacy of their compliance policies and procedures and the effectiveness of their implementation. Currently, there is no requirement to document that review in writing.<sup>292</sup> This rule applies to all investment advisers, not just advisers to private funds.<sup>293</sup> We understand that many investment advisers routinely make and preserve written documentation of the annual review of their compliance policies and procedures, even while the compliance rule does not require such written documentation. Many advisers retain such documentation for use in demonstrating compliance with the rule during an examination by our Division of Examinations. However, based on staff experience, we understand that not

all advisers make and retain such documentation of the annual review.

##### C. Benefits and Costs

##### 1. Overview and Broad Economic Considerations

Private fund investments can be opaque, and we have observed that investors lack sufficiently detailed information about fund fees and expenses and the preferred terms granted to certain investors and often lack sufficient transparency into how private fund performance is calculated. In addition, we have observed that certain sales practices, conflicts of interest, and compensation schemes are either not transparent to investors or can be harmful and have significant negative effects on private fund returns.

The proposed rules would (a) require registered investment advisers to provide certain disclosures in quarterly statements to private fund investors, (b) require all investment advisers, including those that are not registered with the Commission, to make certain disclosures of preferential terms offered to prospective and current investors, (c) prohibit all private fund advisers, including those that are not registered with the Commission, from engaging in certain activities with respect to the private fund or any investor in that private fund, (d) require a registered private fund adviser to obtain an annual financial statement audit of a private fund and, in connection with an adviser-led secondary transaction, a fairness opinion from an independent opinion provider, and (e) impose further

subject to regular inspection is not, however, required to obtain an annual surprise examination if the vehicle distributes the audited financial statements prepared in accordance with generally accepted accounting principles to the pool's investors within 120 days of the end of its fiscal year. See rule 206(4)–2(b)(4).

<sup>287</sup> See *supra* section V.B.3.

<sup>288</sup> For example, annual financial statements may not include both gross and net IRRs and MOICs,

separately for realized and unrealized investments, and without the impact of fund-level subscription facilities. Annual financial statements may also vary in the level of detail provided for portfolio investment-level compensation. See, e.g., Illustrative Financial Statements: Private Equity Funds, KPMG (November 2020), available at <https://audit.kpmg.us/content/dam/advisory/en/pdfs/2020/financial-statements-private-equity-funds-2020.pdf>; Illustrative Financial Statements:

Hedge Funds, KPMG (November 2020), available at <https://audit.kpmg.us/content/dam/advisory/en/pdfs/2020/financial-statements-hedge-funds-2020.pdf>.

<sup>289</sup> See *supra* section II.B.

<sup>290</sup> See rule 204–2 under the Advisers Act.

<sup>291</sup> See rule 204–2(e)(1) under the Advisers Act.

<sup>292</sup> Advisers Act rule 206(4)–7.

<sup>293</sup> *Id.*



requirements, including certain requirements that apply to all fund advisers, to enhance the level of regulatory and other external monitoring of private funds and other clients.

Without Commission action, private funds and private fund advisers would have limited abilities and incentives to implement effective reform. First, it may be difficult for private funds to adopt a common, standardized set of detailed disclosures and practices. This is because investors and advisers compete and negotiate independently of each other, and also because of the substantial complexity of information that fund advisers maintain on their funds and may potentially disclose. For example, and as discussed above, developing an industry standard on fee and expense disclosures would require independent and competing investors and advisers to determine which of management fees, fund expenses, performance-based compensation, monitoring fees, and more should be disclosed and at what frequency.<sup>294</sup> Investors and advisers would face substantial costs in developing a single industry standard that encompasses all of the dimensions considered in this proposal.

Second, fund adviser incentives to develop and implement reforms, such as developing more detailed disclosures, are limited by principal-agent problems that are inherent to the relationship between fund advisers and clients.<sup>295</sup> Advisers to private funds can potentially engage in opportunistic behavior (“hold up”) toward the client in which they exploit their informational advantage or bargaining power over the client, after the client has entered into the relationship.<sup>296</sup> Advisers may also face scenarios in

which they have conflicts of interest between certain investors and their own interests (or “conflicting arrangements”), reducing their incentives to act in the investors’ best interests. Advisers may not have sufficient incentives and abilities to commit to a solution to these problems with existing governance mechanisms. These problems of information asymmetry and post-contractual hold-up are amplified by the inherent discretion that private fund advisers have over what information to disclose to prospective investors and the complexity of the disclosures that they provide. In addition, the incentives of advisers to provide investors with transparency are limited and may depend on the investor’s scale of operations or relationship with the adviser. For example, the adviser of a private fund may choose not to disclose to smaller investors information regarding the preferred terms that are granted to larger investors, even when those terms are material to smaller investor’s choices regarding the fund investment.<sup>297</sup>

These issues carry costs and risks of investor harm in financial markets. The relationship between fund adviser and investor can provide valuable opportunities for diversification of investments and an efficient avenue for the raising of capital, enabling economic growth that would not otherwise occur. However, the current opacity of the market can prevent even sophisticated investors from optimally obtaining certain terms of agreement from fund advisers, and this can result in investors paying excess costs, bearing excess risk, receiving limited and less reliable information about investments, and receiving contractual terms that may reduce their returns relative to what they would obtain otherwise. The proposed rules provide a regulatory solution that addresses these problems and enhances the protection of investors. Moreover, the proposed rules do so in a way that does not deprive fund advisers of compensation for their services: Insofar as the proposed rules shift costs and risks back onto fund advisers, the rules strengthen the incentives of advisers to manage risk in the interest of fund investors and, in doing so, does not preclude fund advisers from responding by raising

prices of services that are not prohibited and are appropriately, transparently disclosed.

*Effects.* In analyzing the effects of the proposed rules, we recognize that investors may benefit from access to more useful information about the fees, expenses, and performance of private funds. They also may benefit from more intensive monitoring of funds and fund advisers by third parties, including auditors and persons who prepare assessments of secondary transactions. Finally, investors may benefit from the prohibition of certain sales practices, conflicts of interest, and compensation schemes that result in investor harm. We recognize that the specific provisions of the proposed rules would benefit investors through each of these basic effects.

*More useful information for investors.* Investors rely on information from fund advisers in deciding whether to continue an investment, how strictly to monitor an ongoing investment or their adviser’s conduct, whether to consider switching to an alternative, whether to continue investing in subsequent funds raised by the same adviser, and how to potentially negotiate terms with their adviser on future investments.<sup>298</sup> By requiring detailed and standardized disclosures across certain funds, the proposal would improve the usefulness of the information that current investors receive about private fund fees, expenses, and performance, and that both current and prospective investors receive about preferential terms granted to certain investors. This would enable them to evaluate more easily the performance of their private fund investments, net of fees and expenses, and to make comparisons among investments. Finally, enhanced disclosures would help investors shape the terms of their relationship with the adviser of the private fund. The rules may also improve the quality and accuracy of information received by investors through the proposed audit requirement, both by providing independent checks of financial statements, and by potentially improving advisers’ regular performance reporting, to the extent that regular audits improve the completeness and accuracy of fund adviser valuation of ongoing investments.

*Enhanced external monitoring of fund investments.* Many investors currently rely on third-party monitoring of funds

<sup>294</sup> See *supra* section V.B.3.

<sup>295</sup> The relationship between an adviser and its client or a fund and its investor is generally one where the principal (the client, here a fund) relies on an agent (the investment adviser) to perform services on the principal’s behalf. See Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 *Journal of Financial Economics* 305–360 (1976). To the extent that principals and their agents do not have perfectly aligned preferences and goals, agents may take actions that increase their well-being at the expense of principals, thereby imposing “agency costs” on the principals. Principals may seek contractual solutions to the principal-agent problem, although these solutions may be limited in the presence of information asymmetry.

<sup>296</sup> The potential for exploitation can be reduced to the extent that investors have strong rights of exit. See, e.g., John Morley, The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation, 123 (5) *Yale Law Journal* 1228–1287 (2014), available at <https://openyls.law.yale.edu/bitstream/handle/20.500.13051/4449/123YaleLJ.pdf?sequence=2&isAllowed=y>.

<sup>297</sup> Results from studies of other markets suggest that mandatory disclosures can cause managers to focus more narrowly on maximizing investor value. See, e.g., Michael Greenstone, Paul Oyer, and Annette Vissing-Jorgensen, Mandated Disclosure, Stock Returns, and the 1964 Security Acts Amendments, 121 (2) *The Quarterly Journal of Economics* 399–460 (May 2006).

<sup>298</sup> For example, private equity fund agreements often allow the adviser to raise capital for new funds before the end of the fund’s life, as long as all, or substantially all, of the money in prior fund has been invested. See, e.g., Gompers and Lerner (2004) and Morley (2014, at 1254).

for prevention and timely detection of specific harms from misappropriation, theft, or other losses to investors. This monitoring occurs through audits and surprise exams or audits under the custody rule, as well as through other audits of fund financial statements. The proposal would expand the scope of circumstances requiring third-party monitoring, and investors would benefit to the extent that such expanded monitoring increases the speed of detection of misappropriation, theft, or other losses and so results in more timely remediation. Audits may also broadly improve the completeness and accuracy of fund performance reporting, to the extent these audits improve fund valuations of their ongoing investments. Even investors who rely on the recommendations of consultants, advisers, private banks, and other intermediaries would benefit from the proposal, to the extent the recommendations by these intermediaries are also improved by the protections of expanded third-party monitoring by independent public accountants.

*Prohibitions of certain activities that are contrary to public interest and to the protection of investors.* Certain practices, even if appropriately disclosed or permitted by private fund offering documents, represent potential conflicts of interest and sources of harm to funds and investors. Because many of these conflicts of interest and sources of harm may be difficult for investors to detect or negotiate terms over, full disclosure of the activities considered in the proposal would not likely resolve the potential investor harm. Further, as discussed above, private funds typically lack fully independent governance mechanisms more common to other markets that would help protect investors from harm in the context of the activities considered.<sup>299</sup> The proposal would benefit investors and serve the public interest by prohibiting such practices.

The costs of the proposed rules would include the costs of meeting the minimum regulatory requirements of the rules, including the costs of providing standardized disclosures and, for some funds, refraining from prohibited activities, and obtaining the required external financial statement audit and fairness opinions. Additional costs would arise from the new compliance requirements of the proposed rules. For example, some advisers would update their compliance programs in response to the requirement to make and keep a record of their

annual review of the program's implementation and effectiveness. Certain fund advisers may also face costs in the form of declining revenue, declining in compensation to fund personnel and a potential resulting loss of employees, or losses of investor capital. However, some of these costs, such as declining compensation to fund personnel, would be a transfer to investors depending on the fund's economic arrangement with the adviser.

Below we discuss these benefits and costs in more detail and in the context of the specific elements of the proposal.

## 2. Quarterly Statements

We are proposing to require a registered investment adviser to prepare a quarterly statement for any private fund that it advises, directly or indirectly, that has at least two full calendar quarters of operating results, and distribute the quarterly statement to the private fund's investors within 45 days after each calendar quarter end, unless such a quarterly statement is prepared and distributed by another person.<sup>300</sup> The rule provides that, to the extent doing so would provide more meaningful information to the private fund's investors and would not be misleading, the adviser must consolidate the quarterly statement reporting to cover, as defined above, substantially similar pools of assets.<sup>301</sup>

We discuss the costs and benefits of this proposal to require a quarterly account statement below. The Commission notes, however, that it is generally difficult to quantify these economic effects with meaningful precision, for a number of reasons. For example, there is a lack of quantitative data on the extent to which advisers currently provide information that would be required to be provided under the proposed rule to investors. Even if these data existed, it would be difficult to quantify how receiving such information from advisers may change investor behavior. In addition, the benefit from the requirement to provide the mandated performance disclosures would depend on the extent to which investors already receive the mandated information in a clear, concise, and comparable manner. As discussed above, however, we believe that the format and scope of these disclosures vary across advisers and private funds, with some disclosures providing limited information while others are more detailed and complex.<sup>302</sup> As a result,

parts of the discussion below are qualitative in nature.

## Quarterly Statement—Fee and Expense Disclosure

The proposed rule would require an investment adviser that is registered or required to be registered and that provides investment advice to a private fund to provide to each of the private fund investors with a quarterly statement containing certain information regarding fees and expenses, including fees and expenses paid by underlying portfolio investments to the adviser or its related persons, is distributed to the fund's investors. The quarterly statement would include a table detailing all adviser compensation to advisers and related persons, fund expenses, and the amount of offsets or rebates carried forward to reduce future payments or allocations to the adviser or its related persons.<sup>303</sup> Further, the quarterly statement would include a table detailing portfolio investment compensation and, for portfolio investments in which portfolio investment compensation was received, certain ownership percentage information.<sup>304</sup> The proposed quarterly statement rule would require each quarterly statement to be distributed within 45 days, include clear and prominent, plain English disclosures regarding the manner in which all expenses, payments, allocations, rebates, waivers, and offsets are calculated, and include cross-references to the sections of the private fund's organizational and offering documents that set forth the applicable calculation methodology.<sup>305</sup>

## Benefits

The effect of this requirement to provide a standardized minimum amount of information in an easily understandable format would be to lower the cost to investors of monitoring fund fees and expenses, lower the cost to investors of monitoring any conflicting arrangements, improve the ability of investors to negotiate terms related to the governance of the fund, and improve the ability of investors to evaluate the value of services provided by the adviser and other service providers to the fund.

For example, investors could more easily compare actual investment returns to the projections they received prior to investing. As discussed above, any waterfall arrangements governing

<sup>299</sup> See *supra* section II.A.

<sup>301</sup> See *supra* section II.A.4.

<sup>302</sup> See *supra* section V.B.3.

<sup>303</sup> See *supra* section II.A.1.a.

<sup>304</sup> See *supra* section II.A.1.b.

<sup>305</sup> See *supra* section II.A.1.c.

<sup>299</sup> See *supra* section V.B.1.

fund adviser compensation may be complex and opaque.<sup>306</sup> As a result, investor returns from a fund may be affected by whether investors are able to follow, and verify, payments that the fund is making to investors and to the adviser in the form of performance-based compensation, as these payments are often only made after investors have recouped the applicable amount of capital contributions and received any applicable preferred returns from the fund. This information may also help investors evaluate whether they are entitled to the benefit of a clawback. This may particularly be the case for deal-by-deal waterfalls, where advisers may be more likely to be subject to a clawback.<sup>307</sup> As discussed above, even sophisticated investors have reported difficulty in measuring and evaluating compensation made to fund advisers and determining if adviser fees comply with the fund's governing agreements.<sup>308</sup> Any such investors would benefit to the extent that the required disclosures under the proposal address these difficulties.

Investors may also find it easier to compare alternative funds or other investments. As a result, some investors may reallocate their capital among competing fund investments and, in doing so, achieve a better match between their choice of private fund and their preferences over private fund terms, investment strategies, and investment outcomes. For example, investors may discover differences in the cost of compensating advisers across funds that lead them to move their assets into funds (if able to do so) with less costly advisers or other service providers. Investors may also have an improved ability to negotiate expenses and other arrangements in any subsequent private funds raised by the same adviser. Investors may therefore face lower overall costs of investing in private funds as a benefit of the standardization. In addition, an investor may more easily detect errors by reading the adviser's disclosure of any offsets or rebates carried forward to subsequent periods that would reduce future adviser compensation. This information would make it easier for investors to understand whether they are entitled to additional reductions in future periods.

Because the rule requires disclosures at both the private-fund level and the portfolio level, investors can more easily evaluate the aggregate fees and expenses of the fund, including the impact of

individual portfolio investments. The private fund level information would allow investors to more easily evaluate their fund fees and expenses relative to the fund governing documents, evaluate the performance of the fund investment net of fees and expenses, and evaluate whether they want to pursue further investments with the same adviser or explore other potential investments. The portfolio investment level information would allow investors to evaluate the fees and costs of the fund more easily in relation to the adviser's compensation and ownership of the portfolio investments of the fund. For example, investors would be able to evaluate more easily whether any portfolio investments are providing compensation that could entitle investors to a rebate or offset of the fees they owe to the fund adviser. This information would also allow investors to compare the adviser's compensation from the fund's portfolio investments relative to the performance of the fund and relative to the performance of other investments available to the investor. To the extent that this heightened transparency encourages advisers to make more substantial disclosures to prospective investors, investors may also be able to obtain more detailed fee and expense and performance data for other prospective fund investments. As a result of these required disclosures, investor choices over private funds may more closely match investor preferences over private fund terms, investment strategies, and investment outcomes.

The magnitude of the effect depends on the extent to which investors do not currently have access to the information that would be reported in the quarterly statement in an easily understandable format. While many advisers not required to send quarterly statements choose to do so anyway, existing quarterly statements are not standardized across advisers and may vary in their level of detail. For example, we understand that many private equity fund governing agreements are broad in their characterization of the types of expenses that may be charged to portfolio investments and that investors receive reports of fund expenses that are aggregated to a level that makes it difficult for investors to verify that the individual charges to the fund are justified.<sup>309</sup> Further, as discussed above, we believe that some investors in hedge

funds operating in reliance on the exemption set forth in CFTC Regulation 4.7 may currently receive quarterly statements that present, among other things, the net asset value of the exempt pool and the change in net asset value from the end of the previous reporting period.<sup>310</sup> While this could have the effect of mitigating some of the benefits of the proposed rule, we do not believe that reports provided to investors pursuant to CFTC Regulation § 4.7 require all of the information, nor their standardized presentation, as required under the proposed rule. The magnitude of the effect also depends on how investors would use the fee and expense information in the quarterly statement. In addition, reports of fund expenses often do not include data about payments at the level of portfolio investments, information about the extent to which fees and expenses are allocated to a given fund versus other similar funds and co-investment accounts, or about how offsets are calculated, allocated and applied. Lack of disclosure has been at issue in enforcement actions against fund managers.<sup>311</sup>

#### Costs

The cost of the proposed changes in fee and expense disclosure would include the cost of compliance by the adviser. For advisers that currently maintain the records needed to generate the required information, the cost of complying with this new disclosure requirement would be limited to the costs of compiling, preparing, and distributing the information for use by investors and the cost of distributing the information to investors. We expect these costs would generally be ongoing costs. Advisers would also incur costs associated with determining and verifying that the required disclosures comply with the format requirements under the proposed rule, including demands on personnel time required to verify that disclosures are made in plain English regarding the manner in which calculations are made and to verify that disclosures include cross-references to the sections of the private fund's organizational and offering documents. This also includes demands on personnel time to verify that the information required to be provided in tabular format is distributed with the correct presentation. Advisers may also choose to undertake additional costs of ensuring that all information in the quarterly statements is drafted

<sup>306</sup> See *supra* section V.B.3.

<sup>307</sup> *Id.*

<sup>308</sup> See *supra* footnote 24 (with accompanying text).

<sup>309</sup> See, e.g., StepStone, *Uncovering the Costs and Benefits of Private Equity* (Apr. 2016), available at [https://www.stepstonegroup.com/wp-content/uploads/2021/07/StepStone\\_Uncovering\\_the\\_Costs\\_and\\_Benefits\\_of\\_PE.pdf](https://www.stepstonegroup.com/wp-content/uploads/2021/07/StepStone_Uncovering_the_Costs_and_Benefits_of_PE.pdf).

<sup>310</sup> See *supra* section V.B.3.

<sup>311</sup> See *supra* footnotes 25–27 (with accompanying text).

consistently with the information in fund offering documents, to avoid inconsistent interpretations across fund documents and resulting confusion for investors. Many of these costs we would expect would be borne more heavily in the initial compliance phases of the rule and would wane on an ongoing basis.

Some of these costs of compliance could be reduced by the rule provision providing that advisers must consolidate the quarterly statement reporting to cover substantially similar pools of assets, avoiding duplicative costs across multiple statements. However, in other cases the rule provision requiring consolidation may further increase the costs of compliance with the proposed rules, not decrease the costs of compliance. For example, in the case where a private fund adviser is preparing quarterly statements for investors in a feeder fund, and therefore consolidating statements between a master fund and its feeder funds, the consolidation may require the adviser to calculate the feeder fund's proportionate interest in the master fund on a consolidated basis. The additional costs of these calculations of proportionate interest in the master fund, to the extent the adviser does not already undertake this practice, may offset any reduced costs the adviser receives from not being required to undertake duplicative costs across multiple statements.

There are other aspects of the rule that would impose costs. The proposed rule would require each portfolio investment table to list the fund's ownership percentage of covered portfolio investments as of the end of the reporting period and impose record-keeping and timing requirements. The costs associated with implementing this requirement are likely to vary among advisers depending on the current record keeping and disclosure practices of the adviser. These costs are likely to be initially higher, but could also vary over time. In addition, some advisers may choose to update their systems and internal processes and procedures for tracking fee and expense information in order to better respond to this disclosure requirement. The costs of those improvements would be an indirect cost of the rule, to the extent they would not occur otherwise, and they are likely to be higher initially than they would be on an ongoing basis.

*Preparation and distribution of Quarterly Statements.* As discussed below, for purposes of the Paperwork Reduction Act of 1995 ("PRA"), we anticipate that the compliance costs associated with preparation and distribution of quarterly statements (including the preparation and

distribution of fee and expense disclosure, as well as the performance disclosure discussed below) would include an aggregate annual internal cost of \$200,643,858 and an aggregate annual external cost of \$112,403,250, or a total cost of \$313,047,108 annually.<sup>312</sup> For costs associated with potential upgrades to fee tracking and expense information systems, funds are likely to vary in the intensity of their upgrades, because for example some advisers may not pursue any system upgrades at all, and moreover the costs may be pursued or amortized over different periods of time. Advisers are similarly likely to vary in their choices of whether to invest in increasing the quality of their services. For both of these categories of costs, the data do not exist to estimate how funds or investors may respond to the reporting requirements, and so the costs may not be practically quantified.

Under the proposed rule, these compliance costs may be borne by advisers and, where permissible, could be imposed on funds and therefore indirectly passed on to investors. For example, under current practice, advisers to private funds generally charge disclosure and reporting costs to the funds, so that those costs are ultimately paid by the fund investors. Also, currently, to the extent advisers use service providers to assist with preparing statements (e.g., fund administrators), those costs often are borne by the fund (and thus indirectly investors). To the extent not prohibited, we expect similar arrangements may be made going forward to comply with the proposed rule. Advisers could alternatively attempt to introduce substitute charges (for example, increased management fees) in order to cover the costs of compliance with the rule, and their ability to do so may depend on the willingness of investors to incur those substitute charges.

Further, to the extent that the additional standardization and comparability of the information in the required disclosures makes it more difficult to charge fees higher than those charged for similar adviser services or otherwise to continue current levels and structures of fees and expenses, the proposal may reduce revenues for some advisers and their related persons. These advisers may respond by reducing their fees or by differentiating their services from those provided by other advisers, including by, for example, increasing the quality of their

services in a manner that could attract additional capital to funds they advise. To the extent these reduced revenues result in reduced compensation for some advisers and their related persons, those entities may become less competitive as employers. However, this cost is likely to be mitigated because some advisers may attract new capital under the proposal, and so those advisers and their related persons may become more competitive as employers.

#### Quarterly statement—Performance Disclosure

Advisers would also be required to include standardized fund performance information in each quarterly statement provided to fund investors. Specifically, the proposed rule would require an adviser to a fund considered a liquid fund under the proposed rule to disclose the fund's annual total returns for each calendar year since inception and the fund's cumulative total return for the current calendar year as of the end of the most recent calendar quarter covered by the quarterly statement.<sup>313</sup> For funds determined to be illiquid funds under the proposed rule, the proposed rule would require an adviser to show the internal rate of return (IRR) and multiple of invested capital (MOIC) (each, on a gross and net basis), the gross IRR and the gross MOIC for the unrealized and realized portions of the portfolio (each shown separately), and a statement of contributions and distributions.<sup>314</sup> Each would be computed without the effect of any fund level subscription facilities.<sup>315</sup> The statement of contributions and distributions would provide certain cash flow information for each fund.<sup>316</sup> Further, advisers would be required to include clear and prominent plain English disclosure of the criteria used and assumptions made in calculating the performance.<sup>317</sup>

#### Benefits

As a result of these performance disclosures, some investors would find it easier to obtain and use information about the performance of their private fund investments. They may, for example, find it easier to monitor the performance of their investments and compare the performance of the private funds in their portfolios to each other and to other investments. In addition, they may use the information as a basis for updating their choices between

<sup>312</sup> See *infra* section VI.B. As explained in that section, this estimated annual cost is the sum of the estimated recurring cost of the proposed rule in addition to the estimated initial cost annualized over the first three years.

<sup>313</sup> See *supra* section II.A.2.a.

<sup>314</sup> See *supra* section II.A.2.b.

<sup>315</sup> *Id.*

<sup>316</sup> *Id.*

<sup>317</sup> See *supra* section II.A.2.c.

different private funds or between private fund and other investments. In doing so, they may achieve a better alignment between their investment choices and preferences. Cash flow information would be provided in a form that allows investors to compare the performance of the fund (or a fund investment) with the performance of other investments, such as by computing PME or other metrics.

We understand that some investors receive the required performance information under the baseline, independently of the proposed rule. For example, some investors receive performance disclosures from advisers on a tailored basis. Those investors may not experience easier access to performance information from the proposal. They may, however, benefit from standardization of the information in quarterly statements across investors in a fund and across advisers. For example, the standardization of the data that a fund provides to all of its investors could benefit some investors by facilitating the development and sharing of tools and methods for analyzing the data among the various investors of the fund. In addition, to the extent that investors share the complete, comparable data with consultants or other intermediaries they work with (as is often current practice to the extent permitted under confidentiality provisions), this may allow such intermediaries to provide broader views across the private funds market or segments of the market. This may facilitate better decision making and capital allocation more broadly.

The required presentation of performance information and the resulting economic benefits would vary based on whether the fund is determined to be a liquid fund or an illiquid fund. For example, for private equity and other funds determined to be illiquid funds, investors would benefit from receiving multiple pieces of performance information, because the shortcomings discussed above that are associated with each method of measuring performance make it difficult for investors to evaluate fund performance from any singular piece of performance information alone, such as IRR or MOIC.<sup>318</sup> For hedge funds, the primary benefit is the mandating of regular reporting of returns by advisers, avoiding any potential biases associated with hedge funds choosing whether and when to report returns.<sup>319</sup> The benefits from the proposed requirements are therefore potentially more substantial

for the funds determined to be illiquid funds, as the breadth of the performance information that would be required under the proposal for the private equity and other funds determined to be illiquid funds is designed to address the shortcomings of individual performance metrics. For both types of funds, because the factors we propose to use to distinguish between liquid and illiquid funds align with the current factors for determining how certain types of private funds should report performance under U.S. GAAP, market participants may be more likely to understand the presentation of performance.

#### Costs

The cost of the required performance disclosure by fund advisers would vary according to the existing practices of the adviser and the complexity of the required disclosure. For advisers who already (under their current practice) incur the costs of generating the necessary performance data, presenting and distributing it in a format suitable for disclosure to investors, and checking the disclosure for accuracy and completeness, the cost would likely be small. In particular, for those advisers, the cost of the performance disclosure may be limited to the cost of reformatting the performance information for inclusion in the mandated quarterly report. However, we understand that some advisers may face costs of changing their performance tracking or reporting practices under the current rule. Some of these costs would be direct costs of the rule requirements. Costs of updating an adviser's internal controls or internal compliance system to verify the accuracy and completeness of the reported performance information would be indirect costs of the rule. We expect the bulk of the costs associated with complying with this aspect of the proposed rules would likely be most substantial initially rather than on an ongoing basis.<sup>320</sup>

Some of these costs of compliance could again be affected by the rule provision providing that advisers must consolidate the quarterly statement reporting to cover substantially similar pools of assets. These costs of compliance would be reduced to the extent that advisers are able to avoid duplicative costs across multiple statements, but would be increased to the extent that advisers must undertake costs associated with calculating feeder fund proportionate interests in a master

fund, to the extent advisers do not already do so.

The required presentation of performance, and the resulting costs, would vary based on whether the fund is categorized as liquid or illiquid. In particular, for funds determined to be liquid funds, the cost is mitigated by the limited nature of the required disclosure, as the proposal requires only annual total returns and cumulative total returns for the current calendar year as of the end of the most recent calendar quarter covered, while the more detailed required disclosures for funds determined to be illiquid funds may require greater cost (yielding, as just discussed, greater benefit).<sup>321</sup> For both categories of funds, because the factors we proposed to use to distinguish between liquid and illiquid funds align with the current factors for determining how certain types of private funds should report performance under U.S. GAAP, and as a result, market participants may be more familiar with these methods of presenting information, which may mitigate costs.

Under the proposed rule, these compliance costs may be borne by advisers and, where permissible, could be imposed on funds and therefore indirectly passed on to investors. For example, under current practice, advisers to private funds generally charge disclosure and reporting costs to the funds, so that those costs are ultimately paid by the fund investors. Similarly, to the extent advisers currently use service providers to assist with performance reporting (e.g., administrators), those costs are often borne by the fund (and thus investors). To the extent not prohibited, we expect similar arrangements may be made going forward to comply with the proposed rule. Advisers could alternatively attempt to introduce substitute charges (for example, increased management fees) in order to cover the costs of compliance with the rule, but their ability to do so may depend on the willingness of investors to incur those substitute charges.

Further, to the extent that the additional standardization and comparability of the information in the required disclosures make it easier for investors to compare and evaluate performance, the rule may prompt some investors to search for and seek higher performing investment opportunities. This could reduce the ability for advisers of low-performing funds to attract additional capital. By the same rationale, the rule may prompt some

<sup>320</sup> The quantification of the direct costs associated with completing performance disclosures is included in the analysis of costs associated with fee and expense disclosures above.

<sup>321</sup> See *supra* section II.A.2.a and II.A.2.b.

<sup>318</sup> See *supra* section V.B.3.

<sup>319</sup> *Id.*

investors to search for and seek higher performing investment opportunities, further reducing the ability for advisers of low-performing funds to attract additional capital.

### 3. Prohibited Activities and Disclosure of Preferential Treatment

The proposed rules would prohibit a private fund adviser from engaging in certain activities with respect to the private fund or any investor in that private fund, including (i) charging certain regulatory and compliance fees and expenses or fees or expenses associated with certain examinations or investigations,<sup>322</sup> (ii) charging fees for certain unperformed services,<sup>323</sup> (iii) certain non-pro rata fee and expense allocations,<sup>324</sup> (iv) borrowing money, securities, or other fund assets, or receiving a loan or an extension of credit, from a private fund client,<sup>325</sup> (v) reducing the amount of any adviser clawback by the amount of certain taxes,<sup>326</sup> (vi) limiting or eliminating liability for certain adviser misconduct,<sup>327</sup> and (vii) granting an investor in the private fund or a substantially similar pool of assets preferential terms regarding liquidity or transparency that the adviser reasonably expects to have a material, negative effect on other investors in the fund or a substantially similar pool of assets.<sup>328</sup> In addition, we also propose to prohibit all private fund advisers from providing any other preferential treatment to any investor in the private fund unless the adviser provides written disclosures to prospective and current investors.<sup>329</sup> These prohibitions would apply to activities of the private fund advisers even if they are performed indirectly, for example, by an adviser's related persons, recognizing that the potential for harm to the fund and its investors arises independently of whether the adviser engages in the activity directly or indirectly.<sup>330</sup>

We discuss the costs and benefits of each of these prohibitions and requirements below. The Commission notes, however, that several factors make the quantification of many of these economic effects of the proposed amendments and rules difficult. For example, there is a lack of data on the extent to which advisers engage in certain of the activities that would be

prohibited under the proposed rules, as well as their significance to the businesses of such advisers. It is, therefore, difficult to quantify how costly it would be to comply with the prohibitions. Similarly, it is difficult to quantify the benefits of these prohibitions, because there is a lack of data regarding how and to what extent the changed business practices of advisers would affect investors, and how advisers may change their behavior in response to these prohibitions. Further, there is a lack of data on the frequency with which advisers grant certain investors the preferential treatment that would be prohibited under the proposed rules, as well as the frequency with which preferential terms are currently disclosed to other investors, as well as how and to what extent these disclosures affect investor behavior. As a result, parts of the discussion below are qualitative in nature.

#### Certain Fees and Expenses

The proposal would prohibit a private fund adviser from charging the fund for fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority or for the regulatory and compliance fees and expenses of the adviser or its related persons.<sup>331</sup> The benefit to investors would be to lower charges on the funds they have invested in, which could increase returns, and potentially lower the cost of effort to avoid and evaluate such charges, or a combination of these benefits. To the extent that these charges, even when disclosed, create adverse incentives for advisers to allocate expenses to the fund at a cost to the investor, they represent a possible source of investor harm. For example, when these charges are in connection with an investigation of an adviser, it may not be in the fund's best interest to bear the cost of the investigation.<sup>332</sup> These fees may also, even when disclosed, incentivize advisers to engage in excessive risk-taking, as the adviser will no longer bear the cost of any ensuing government or regulatory examinations or investigations.<sup>333</sup> By

prohibiting this activity, investors would benefit from the reduced risk of having to incur costs associated with the adviser's adverse incentives, such as allocating inappropriate expenses to the fund. Investors would also be able to search across fund advisers knowing that these charges would not be assessed on any fund, which may lead to a better match between investor choices of private funds and their preferences over private fund terms, investment strategies, and investment outcomes. The magnitude of the benefit would to some extent depend on whether advisers could introduce substitute charges (for example, increased management fees), and the willingness of investors to incur those substitute charges, for the purpose of making up any revenue that would be lost to the adviser from the prohibition. However, any such substitute charges would be more transparent to the investor and would not create the same adverse incentives as the prohibited charges, and so investors would likely ultimately still benefit.

This prohibition would impose direct costs on advisers from the need to update their charging and contracting practices to bring them into compliance with the new requirements. Advisers would also incur costs related to this prohibition, in connection with not being able to charge private fund clients for the prohibited expenses. In addition, advisers may incur indirect costs related to adapting their business models in order to identify and substitute non-prohibited sources of revenue. For example, advisers may identify and implement methods of replacing the lost charges from the prohibited practice with the other sources of fund revenue. These costs would likely be transitory.

Further, as discussed above, we understand that certain private fund advisers, most notably hedge funds and other funds determined to be liquid funds,<sup>334</sup> that utilize a pass-through expense model where the private fund pays for most, if not all, of the adviser's expenses in lieu of being charged a management fee. The proposed rules would likely prohibit certain aspects of pass-through expense models or other similar models in which advisers charge investors fees associated with certain of the adviser's cost of being an investment adviser. These expenses that would no longer be passed through to the fund could represent additional costs to the fund adviser, unless the adviser

<sup>331</sup> See *supra* section II.D.2.

<sup>332</sup> *Id.*

<sup>333</sup> Fund adviser fees can allow the adviser to obtain leverage, and thereby gain disproportionately from successes, encouraging advisers to take on additional risk. See, e.g., Alon Brav, Wei Jiang, and Rongchen Li, Governance by Persuasion: Hedge Fund Activism and Market-Based Shareholder Influence, *European Corporate Governance Institute—Finance* (Working Paper No. 797/2021) (December 10, 2021), available at <https://ssrn.com/abstract=3955116> or <http://dx.doi.org/10.2139/ssrn.3955116>.

<sup>334</sup> See, e.g., Welcome To Hedge Funds' Stunning Pass-Through Fees, *Seeking Alpha* (January 24, 2017), available at <https://seekingalpha.com/article/4038915-welcome-to-hedge-funds-stunning-pass-through-fees>.

<sup>322</sup> See *supra* section II.D.2.

<sup>323</sup> See *supra* section II.D.1.

<sup>324</sup> See *supra* section II.D.5.

<sup>325</sup> See *supra* section II.D.6.

<sup>326</sup> See *supra* section II.D.3.

<sup>327</sup> See *supra* section II.D.4.

<sup>328</sup> See *supra* section II.E.

<sup>329</sup> *Id.*

<sup>330</sup> See *supra* section II.D, II.E.

negotiates a new fixed management fee to compensate for the new costs. In addition, any such fund restructurings that are undertaken would likely impose costs that would be borne by advisers. The costs may also be borne partially or entirely by the private funds, to the extent permissible or to the extent advisers are able to compensate for their costs with substitute charges (for example, increased management fees). These costs would likely be transitory. In addition, investors may incur costs from this prohibition that take the form of lower returns from some fund investments, depending on the extent to which the prohibition limits the adviser's efficiency or effectiveness in providing the services that generate returns from those investments. For example, in the case of pass-through expense models, fund advisers who would have to bear new costs of providing certain services under the prohibition may reduce or eliminate those services from the fund in order to reduce costs, which may be to the detriment of the fund's performance or lead to an increase of compliance risk.

Moreover, to the extent that restructuring a pass-through expense model of a hedge fund under the proposal diverts the hedge fund's resources away from the hedge fund's investment strategy, this could lead to a lower return to investors in hedge funds. The cost of lower returns would be mitigated to the extent that investors can distinguish and identify those funds that require restructuring as to how they collect revenue from investors and use this information to search for and identify substitute funds that have expense models that do not need to be restructured under the rule and that do not present the investor with reduced returns as a result of the rule. Investors would also need to be able to evaluate whether these substitute funds would be likely to present them with better performance than their current funds. Any such search costs would be a cost of the rule. As a result, the cost to investors may include a combination of the cost of lower returns and the cost of avoiding such reductions in returns.

#### Fees for Unperformed Services

In addition, the proposal would prohibit a private fund adviser from charging a portfolio investment for monitoring, servicing, consulting or other fees in respect of services that the adviser does not, or does not reasonably expect, to provide to the portfolio investment, such as through an accelerated payment. As discussed above, these fees are likely to reflect conflicts of interest between the fund

and the adviser that are difficult for the investor to detect and mitigate.<sup>335</sup> For example, in receiving the accelerated payment, discussed above, the adviser imposes a charge for services that it may not provide.<sup>336</sup> An adviser also may have an incentive to cause the fund to exit a portfolio investment earlier than anticipated, which may result in the fund receiving a lesser return on its investment.<sup>337</sup> Because adviser misconduct in response to these incentives may be difficult for investors to detect, full disclosure of this practice does not resolve the conflict of interest. Under the proposed prohibition, investors would be able to choose among fund advisers and invest knowing that they would not face the costs of such conflicts of interests, which also may lead to a better match between investor choices of private funds and their preferences over private fund terms, investment strategies, and investment outcomes.

Investors would also benefit directly via lower costs from the prohibition through the elimination of the fees charged to the fund's portfolio investment.<sup>338</sup> These cost savings could be partially mitigated, however, to the extent that advisers are using portions of the proceeds from the accelerated payment to cover costs of services that benefit the fund client.<sup>339</sup>

This prohibition would impose direct costs on advisers from the need to update their charging and contracting practices to bring them into compliance with the new requirements. Advisers would also incur costs related to this prohibition in connection with not being able to receive these charges for unperformed services. For example, advisers would incur costs in connection with not being able to receive the accelerated payments, and as a result, advisers could attempt to replace the accelerated payments with some new fee or charge. Advisers could, therefore, incur transitory costs related to adapting their business models in order to identify and substitute non-prohibited sources of revenue. These costs may be particularly high in the short term to the extent that advisers re-negotiate, re-structure and/or revise certain existing deals or existing

economic arrangements in response to this prohibition.

In addition, investors may incur some costs from this prohibition that take the form of lower returns from certain fund investments, depending on the extent to which the fund adviser's loss of revenue from the prohibited activity diverts resources away from the fund's investment strategy. For example, the loss of revenue under this prohibition could cause some advisers to update their portfolio investment strategies, so that they are less reliant on the prohibited fees for revenue. The advisers could limit their portfolio investments that are reliant on accelerated payments for revenue, for example. This could lead to a cost to investors in the form of reduced returns from those investments. Investors could mitigate this cost to the extent that they can distinguish and identify those funds that require restructuring as to how they collect revenue from investors and use this information to search for and identify substitute funds that do not present the investor with reduced returns as a result of the rule. Investors would also need to be able to evaluate whether these substitute funds would be likely to present them with better performance than their current funds. These alternative search costs would be a cost of the rule. As a result, the cost of the prohibition to investors could thus include a combination of the cost of lower returns and the cost of avoiding such reductions in returns.

#### Certain Non-Pro Rata Fee and Expense Allocations

The proposal would prohibit a private fund adviser from charging certain fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment.<sup>340</sup>

These non-pro rata fee and expense allocations tend to adversely affect some investors who are placed at a disadvantage to other investors. We associate these practices and disadvantages with a tendency towards opportunistic hold-up of investors by advisers, involving exploitation of an informational or bargaining advantage.<sup>341</sup> The disadvantaged investors currently pay greater than their pro rata shares of fees and expenses. The disparity may arise from

<sup>335</sup> See *supra* section II.D.1.

<sup>336</sup> *Id.*

<sup>337</sup> See *supra* section II.D.1.

<sup>338</sup> The portfolio investments themselves may also benefit directly from no longer paying these fees.

<sup>339</sup> As discussed above, the proposal would not prohibit an arrangement where the adviser shifts 100% of the economic benefit of a portfolio investment fee to the private fund investors, whether through an offset, rebate, or otherwise. See *supra* section II.D.1.

<sup>340</sup> See *supra* section II.D.5.

<sup>341</sup> See *infra* (discussing opportunism in the context of certain preferential treatment).



differences in the bargaining power of different investors. For example, a fund adviser may have an incentive to assign lower than pro rata shares of fees and expenses to larger investors that bring repeat business to the adviser and correspondingly lower pro rata shares to the smaller investors paying greater than pro rata shares.

Investors could either benefit or face costs from the resulting revised apportionment of expenses to the fund they are invested in, based on whether their share of expenses is decreased or increased under the rule. Investing clients in these portfolio investments paying greater than pro rata shares of such fees and expenses would benefit as a result of lowered fees. However, to the extent that a client was previously able to obtain fee and expense allocations at rates less than a pro rata apportionment, the client could incur higher fee and expense costs in the future. Investors may not be aware of the extent to which fees are charged on a non pro-rata basis. Even if disclosed, the complexity of fee arrangements may mean that these arrangements are hard to follow. More sophisticated investors may be aware that they risk non pro-rata fees, but nonetheless be harmed by the uncertainty from complex fee arrangements. Fund advisers may face a commitment problem in that they and their clients might be better off if they could commit to pro-rata arrangements; thus a prohibition could serve as a net benefit to clients and advisers.<sup>342</sup>

This prohibition would impose direct costs on advisers to updating their charging and contracting practices to bring them into compliance with the new requirements. These compliance costs may be particularly high in the short term to the extent that advisers re-negotiate, re-structure, and/or revise certain existing deals or existing economic arrangements in response to this prohibition. Advisers may face additional costs in the form of lower expenses and fees, to the extent that less flexible pro-rata fee and expense allocations result in lower average fees and expenses to the adviser or are more costly to administer and monitor.

#### Borrowing

The proposal prohibits an adviser, directly or indirectly, from borrowing money, securities, or other fund assets, or receiving a loan or an extension of credit, from a private fund client.<sup>343</sup> In

cases where, as the Commission has observed, fund assets were used to address personal financial issues of one of the adviser's principals, used to pay for the advisory firm's expenses, or used in association with any other harmful conflict of interest,<sup>344</sup> then this prohibition would increase the amount of fund resources available to further the fund's investment strategy. Investors would benefit from any resulting increased payout. In addition, investors would benefit from the elimination or reduction of any need to engage in costly research or negotiations with the adviser to prevent the uses of fund resources by the adviser that would be prohibited. The prohibition also has the potential to benefit investors by reducing moral hazard: If an adviser borrows from a private fund client and does not pay back the loan, it is the investors who bear the cost, providing the adviser with incentives to engage in potentially excessive borrowing.

Advisers may experience costs as a result of this prohibition related to any marginal increases in the cost of capital incurred from new sources of borrowing, as compared to what was being charged by the fund.

#### Reducing Adviser Clawbacks for Taxes

The proposed rule would prohibit certain uses of fund resources by the private fund adviser by prohibiting advisers from reducing the amount of their clawback obligation by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders.<sup>345</sup> Some investors would benefit from this rule from effectively increasing clawbacks (and thus investor returns) by actual, potential, or hypothetical tax rates. Investors would also benefit from the elimination or reduction of any need to engage in costly research or negotiations with the adviser to prevent these uses of fund resources by the adviser. These benefits would likely be more widespread, as such research or negotiations may have been necessary at the start of fund lives even in cases where investor returns were not ultimately impacted by tax treatments of clawbacks. Advisers, however, may be unable to recoup the cost of the tax payments made in connection with the excess distributions and allocations affected by the rule, and therefore would face greater costs when clawbacks do occur under the prohibition.

This prohibition would impose direct costs on advisers of updating their charging and contracting practices to bring them into compliance with the new requirements. Advisers may also attempt to mitigate the greater costs of clawbacks under the prohibition by introducing some new fee, charge, or other contractual provision that would make up for the lost tax reduction on the clawback, and they would then incur costs of updating their contracting practices to introduce these new provisions.

Advisers may attempt to mitigate their increased costs associated with clawbacks by reducing the risk of a clawback occurring. For example, certain advisers may adopt new waterfall arrangements designed to delay carried interest payments until later in the life of a fund, in order to limit the possibility of a clawback or reduce the possible sizes of clawbacks. In this case, investors would benefit from earlier distributions of proceeds from the fund and reduced costs associated with monitoring their potential need for a clawback. However, some fund advisers are able to attract investors even though their fund terms do not provide for full or partial clawbacks. To the extent such advisers were able to update their business practices, for example by providing for an advance on tax payments with no option for a clawback, this would reduce the benefit of the proposal, as investors would continue to receive the reduced clawback amounts and bear portions of the adviser's tax burden. In either case, advisers would also bear additional costs from the proposal of updating their business practices.

Advisers could, therefore, incur transitory costs related to adapting their business models in order to identify and substitute non-prohibited sources of revenue. These direct costs may be particularly high in the short term to the extent that advisers re-negotiate, re-structure, and/or revise certain existing deals or existing economic arrangements in response to this prohibition.

#### Limiting or Eliminating Liability for Adviser Misconduct

In addition, the proposal would prohibit an adviser to a private fund, directly or indirectly, from seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund.<sup>346</sup> These practices, even

<sup>342</sup> In a related setting, ex ante commitment to a financing policy has been argued to raise value and lower the cost of capital. See Peter DeMarzo, Presidential Address, Collateral and Commitment, *Journal of Finance*, (July 15 2019).

<sup>343</sup> See *supra* section II.D.6.

<sup>344</sup> *Id.*

<sup>345</sup> See *supra* section II.D.4.

<sup>346</sup> See *supra* section II.D.4.

when disclosed and permissible under state law, may involve breaches of fiduciary duty to the fund or investors, and possible harms to investors, and so investors will likely benefit from their prohibition. For example, because investors may be unable to anticipate willful malfeasance by their fund advisers, they may be unable to anticipate the costs associated with an adviser seeking reimbursement for its malfeasance, even if the adviser discloses that possibility.<sup>347</sup> Investors would therefore benefit from the elimination of fund expenses, which would otherwise reduce investor returns, associated with reimbursing or indemnifying the adviser for losses associated with its malfeasance. These benefits may be diminished to the extent that advisers are able to obtain alternative permissible sources of compensation for these expenses from investors (for example, from increased management fees), although this ability would likely be limited.

Further, these contractual clauses may lead investors to believe that they do not have any recourse in the event of such a breach. To the extent that any such investors do not seek damages under this belief, the contractual clauses eliminating liability for breach of fiduciary duty would represent a harm to the investors. By prohibiting these scenarios, this proposal could make such breaches of fiduciary duty incrementally less likely to occur. Investors would therefore benefit from a reduced need to engage in costly research or negotiations with the adviser to prevent such breaches.

#### Certain Preferential Terms

The proposal would prohibit a private fund adviser from providing certain preferential terms to some investors that have a material negative effect on other investors in the private fund or in a substantially similar pool of assets. We associate these practices with a tendency towards opportunistic hold-up of investors by advisers, involving the exploitation of an informational or bargaining advantage by the adviser or advantaged investor.<sup>348</sup> The proposal would prohibit a private fund adviser and its related persons from granting an investor in the private fund or in a substantially similar pool of assets the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets.<sup>349</sup> In

addition, the proposal would prohibit an adviser and its related persons from providing information regarding the private fund's or a substantially similar pool of asset's portfolio holdings or exposures to an investor that the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets.<sup>350</sup>

Benefits may accrue from these prohibitions in two situations. First, the prohibitions may benefit the non-preferred investors in situations where advisers lack the ability to commit to avoid the opportunistic behavior after entering into the agreement (or relationship) with the investor. For example, similar to the case regarding non-pro rata fee and expense allocations, an adviser with repeat business from a large investor with early redemption rights and smaller investors with no early redemption rights may have adverse incentives to take on extra risk, as the adviser's preferred investor could exercise its early redemption rights to avoid the bulk of losses in the event an investment begins to fail. The adviser would then continue to receive repeat business with the investors with preferential terms, to the detriment of the investors with no preferential terms.

Investors who do receive preferential terms may also receive information over the course of a fund's life that the investors can use to their own gain but to the detriment of the fund and, by extension, the other investors. For instance, if a fund was heavily invested in a particular sector and an investor with early redemption rights learned the sector was expected to suffer deterioration, that investor could submit a redemption request, securing their funds early but forcing the fund to sell assets in a declining market, harming the other investors. In this situation, the prohibitions would provide a solution to the hold-up problem that is not currently available. The rule would benefit the disadvantaged investors by prohibiting such a situation, and so the disadvantaged investors would be less susceptible to hold-up and experience better performance on their fund investments as a benefit of the proposed rule.

Second, in situations where investors face uncertainty as to whether the adviser engages in the prohibited practice, the benefit from the prohibition would be to eliminate the costs to investors of avoiding entering into agreements with advisers that engage in the practice and the costs to

investors from inadvertently entering into such agreements.

Specifically, in this second case, the prohibited preferential terms would harm investors in private funds and cause investors to incur extra costs of researching fund investments to avoid fund investments in which the prospective fund adviser engages in these practices (or costs of otherwise avoiding or mitigating the harm to those disadvantaged investors from the practice). The benefit of the prohibition to investors would be to eliminate such costs. It would prohibit disparities in treatment of different investors in substantially similar pools of assets in the case where the disparity is due to the adviser placing their own interests ahead of the client's interests or due to behavior that may be deceptive. Investors would benefit from the costs savings of no longer needing to evaluate whether the adviser engages in such practices. Investors and advisers also may benefit from reduced cost of negotiating the terms of a fund investment. Investors who would have been harmed by the prohibited practices would benefit from the elimination of such harms through their prohibition.

The cost of the prohibitions would depend on the extent to which investors would otherwise obtain such preferential terms in their agreements with advisers and the conditions under which they make use of the preferential treatment. Investors who would obtain and make use of the preferential terms would incur a cost of losing the prohibited redemption and information rights. This would include any investors who might benefit from the ability to redeem based on negotiated exceptions to the private fund's stated redemption terms, in addition to the investors who might benefit from the hold-up problems discussed above. In addition, advisers would incur direct costs of updating their processes for entering into agreements with investors, to accommodate what terms could be effectively offered to all investors once the option of preferential terms to certain investors has been removed. These direct costs may be particularly high in the short term to the extent that advisers re-negotiate, re-structure and/or revise certain existing deals or existing economic arrangements in response to this prohibition.

To the extent advisers respond to the prohibition by developing new preferential terms and disclosing them to all investors, there may be new costs to investors who do not receive these new preferential terms. As discussed below, such costs would be mitigated by

<sup>347</sup> *Id.*

<sup>348</sup> See *supra* section II.E.

<sup>349</sup> *Id.*

<sup>350</sup> *Id.*

the prohibition of such preferential terms unless appropriately disclosed.

#### Prohibition of Other Preferential Treatment Without Disclosure

The proposed rule also would prohibit other preferential terms unless the adviser provides certain written disclosures to prospective and current investors, and these disclosures must contain information regarding all preferential treatment the adviser provides to other investors in the same fund.<sup>351</sup> This would reduce the risk of harm that some investors face from expected favoritism toward other investors, and help investors understand the scope of preferential terms granted to other investors, which could help investors shape the terms of their relationship with the adviser of the private fund. Because these disclosures would need to be provided to prospective investors prior to their investments and to current investors annually, these disclosures would help investors shape the terms of their relationship with the adviser of the private fund. This may lead the investor to request additional information on other benefits to be obtained, such as co-investment rights, and would allow an investor to understand better certain potential conflicts of interest and the risk of potential harms or other disadvantages.

Disclosures of such preferential treatment would impose direct costs on advisers to update their contracting and disclosure practices to bring them into compliance with the new requirements, including by incurring costs for legal services. These direct costs may be particularly high in the short term to the extent that advisers re-negotiate, re-structure and/or revise certain existing deals or existing economic arrangements in response to this prohibition. However, these costs may also be reduced by an adviser's choice between not providing the preferential terms and continuing to provide the preferential terms with the required disclosures, as the costs to some advisers from not providing the preferential terms to investors may be lower than the costs from the disclosure.

As discussed below, for purposes of the PRA, we anticipate that the disclosure of preferential treatment would impose an aggregate annual internal cost of \$128,902,375 and an aggregate annual external cost of \$32,550,000, or a total cost of \$161,452,375 annually.<sup>352</sup> To the extent

that advisers are not prohibited from categorizing all or a portion of these costs as expenses to be borne by the fund, then these costs may be borne indirectly by investors to the fund instead of advisers.

To the extent that these disclosures could discourage advisers from providing certain preferential terms in the interest of avoiding future negotiations with other investors on similar terms, this prohibition could ultimately decrease the likelihood that some investors are granted preferential terms. As a result, some investors may find it harder to secure such terms.

#### 4. Audits, Fairness Opinions, and Documentation of Annual Review of Compliance Programs

The proposed audit rule would require an investment adviser that is registered or required to be registered to cause each private fund that it advises, directly or indirectly, to undergo a financial statement audit that meets certain elements at least annually and upon liquidation, if the private fund does not otherwise undergo such an audit. These audits would need to be performed by an independent public accountant that meets certain standards of independence and is registered with and subject to regular inspection by the PCAOB, and the statements would need to be prepared in accordance with U.S. GAAP or, for foreign private funds, must contain information substantially similar to statements prepared in accordance with U.S. GAAP, with material differences with U.S. GAAP reconciled.<sup>353</sup> The rule would also require that auditors notify the Commission in certain circumstances.

In addition, the rule would require advisers to obtain fairness opinions from an independent opinion provider in connection with certain adviser-led secondary transactions with respect to a private fund. This requirement would not apply to advisers that are not required to register as investment advisers with the Commission, such as state-registered advisers and exempt reporting advisers. In connection with this fairness opinion, the proposal would also require a summary of any material business relationships the adviser or any of its related persons has, or has had within the past two years, with the independent opinion provider. The proposal would lastly require all advisers, not just those to private funds, to document the annual review of their

estimated recurring cost of the proposed rule in addition to the estimated initial cost annualized over the first three years.

<sup>353</sup> *Id.*

compliance policies and procedures in writing.

We discuss the costs and benefits of these rule provisions below. The Commission notes, however, several factors make the quantification of many of the economic effects of the proposed amendments and rules difficult. For example, there is a lack of quantitative data on the extent to which adviser-led secondaries without fairness opinions differ in fairness of price from adviser-led secondaries with fairness opinions attached. It would also be difficult to quantify how investors and advisers may change their preferences over secondary transactions once fairness opinions are required to be provided. As a result, parts of the discussion below are qualitative in nature.

#### Benefits

We recognize that many advisers already provide audited fund financial statements to fund investors in connection with the adviser's alternative compliance with the custody rule. However, to the extent that an adviser does not currently have its private fund client undergo a financial statement audit, investors would receive more reliable information from private fund advisers as a result of the proposed audit rule. The benefit to investors in securitized asset funds may be relatively greater from the proposal, given the relatively lower frequency with which securitized asset funds currently undergo financial statement audits.<sup>354</sup>

The audit requirement would provide an important check on the adviser's valuation of private fund assets, which often serve as the basis for the calculation of the adviser's fees. These audits would likely detect valuation irregularities or errors, as well as an investment adviser's loss, misappropriation, or misuse of client investments. It may thereby limit some opportunities for advisers to materially over-value investments. Audits provide substantial benefits to private funds and their investors because audits also test other assertions associated with the investment portfolio (e.g., completeness, existence, rights and obligations, presentation). Audits may also provide a check against adviser misrepresentations of performance, fees, and other information about the fund. Enhanced and standardized regular auditing may therefore broadly improve the completeness and accuracy of fund performance reporting, to the extent these audits improve fund valuations of their ongoing investments.

<sup>354</sup> See *supra* section V.B.4.

<sup>351</sup> See *supra* section I.E.

<sup>352</sup> See *infra* section V.E. As explained in that section, this estimated annual cost is the sum of the

Investors who are not currently provided with audited fund financial statements, and who would be under the proposal, may, as a result, have additional confidence in information regarding their investments and, in turn, the fees being paid to advisers. Further, this additional confidence may facilitate investors' capital allocation decisions. Anticipating a lower risk of harm from a private fund investment, investors may be more likely to invest in private funds and participate in the resulting returns.

As discussed above, currently not all financial statement audits are necessarily conducted by a PCAOB-registered independent public accountant that is subject to regular inspection.<sup>355</sup> The proposed audit rule's requirement that the independent public accountant performing the audit be registered with, and subject to regular inspection by, the PCAOB, is likely to improve the audit and financial reporting quality of private funds.<sup>356</sup> Higher quality audits generally have a greater likelihood of detecting material misstatements due to fraud or error, and we further believe that investors would likely have relatively greater confidence in the quality of audits conducted by an independent public accountant registered with, and subject to regular inspection by, the PCAOB.<sup>357</sup> Lastly, we believe that the proposed audit rule's requirement to promptly distribute the audited financial statements to current investors would allow investors to evaluate the audited financial information in the audit in a timely manner.

In addition, investors would benefit from enhanced regulatory oversight as a result of the requirement for the adviser to engage the auditor to notify the Commission under some conditions.<sup>358</sup>

The proposed requirement for the auditor to report terminations and modified opinions privately to the SEC would enable the SEC to receive more timely, complete, and independent information in these circumstances and to evaluate the need for an examination of the adviser. As a result, the SEC would be able to allocate its resources more efficiently. This could lead to a higher rate of detection of fund adviser activities that lead to harms from misstatements and a greater potential for mitigation of such harms. Anticipating this, fund advisers would have stronger incentives to avoid such harmful activities.

The proposal's requirement that an adviser distribute a fairness opinion and summary of material business relationships with the opinion provider in connection with certain adviser-led secondary transactions may provide similar increases in investor confidence in the specific context of adviser-led secondary transactions. This requirement would provide an important check against an adviser's conflicts of interest in structuring and leading these transactions. Investors would have decreased risk of experiencing harm from mis-valuation of secondary-led transactions. Further, anticipating a lower risk of harm from mis-valuation when participating in such transactions, investors may be more likely to participate. The result may be a closer alignment between investor choices and investor preferences over private fund terms, investment strategies, and investment outcomes. These benefits would, however, be reduced to the extent that advisers are already obtaining fairness opinions as a matter of best practice.

Finally, this proposed rule amendment would require all SEC-registered advisers to document the annual review of their compliance policies and procedures in writing. This would allow our staff to better determine whether an adviser has complied with the review requirement of the compliance rule, and would facilitate remediation of non-compliance. Because our staff's determination of whether the adviser has complied with the compliance rule will become more effective, the rule may reduce the risk of non-compliance, as well as any risk to investors associated with non-compliance.

These benefits from mandatory audits and fairness opinions are particularly relevant for illiquid investments. Illiquid assets currently are where we

believe it is most feasible for financial information to have material misstatements of investment values, for adviser-led secondary transactions to occur at unfair prices, and where there is broadly a higher risk of investor harm from potential conflicts of interest or fraud. This is because currently, as discussed above, advisers may use a high level of discretion and subjectivity in valuing a private fund's illiquid investments, and the adviser further may have incentives to bias the fair value estimates of the investment upwards in order to generate larger fees.<sup>359</sup> Because both funds determined to be liquid funds and illiquid funds may have illiquid investments, investors in both types of funds will benefit, though the benefits may be larger for investors in illiquid funds (as such funds may have more illiquid investments than liquid funds and are more likely to have adviser-led secondary transactions). The benefits from documentation of compliance programs will be relevant for all investors, as the rule applies to all fund advisers, not just private fund advisers.

#### Costs

As discussed above, we recognize that many advisers already provide audited financial statements to fund investors in connection with the adviser's alternative compliance with the custody rule.<sup>360</sup> To the extent that an adviser does not currently have its private fund client undergo the required financial statement audit, there would be direct costs of obtaining the auditor, providing the auditor with resources needed to conduct the audit, the audit fees, and promptly distributing the audit results to current investors. We recognize that the proposed audit rule's requirement to promptly distribute the audited financial statements to current investors after the audit's completion may also impose compliance costs, which would be mitigated by the flexibility of the proposal's requirement for prompt distribution, relative to a requirement for distribution to occur by a specific deadline. Under current practice, the costs of undergoing a financial statement audit are often paid by the fund, and therefore, ultimately, by the fund investors, though in some cases the costs may be partially or fully paid by the adviser. To the extent not prohibited, we expect similar arrangements may be made going forward to comply with the proposed rule: In some instances, the fund will bear the audit expense, in others the

<sup>355</sup> See *supra* section V.B.4.

<sup>356</sup> See, e.g., Daniel Aobdia, The Impact of the PCAOB Individual Engagement Inspection Process—Preliminary Evidence, 93 (4) *The Accounting Review* 53–80 (2018) (concluding that “engagement-specific PCAOB inspections influence non-inspected engagements, with spillover effects detected at both partner and office levels” and that “the information communicated by the PCAOB to audit firms is applicable to non-inspected engagements”); Daniel Aobdia, The Economic Consequences of Audit Firms' Quality Control System Deficiencies, 66 (7) *Management Science* (July 2020) (concluding that “common issues identified in PCAOB inspections of individual engagements can be generalized to the entire firm, despite the PCAOB claiming that its engagement selection process targets higher-risk clients” and that “[PCAOB quality control] remediation also appears to positively influence audit quality”).

<sup>357</sup> *Id.*

<sup>358</sup> This requirement does not exist under the custody rule, and as a result, the benefits and costs associated with this requirement would extend to even those investors and funds for which advisers

are already distributing audits under the custody rule.

<sup>359</sup> See *supra* section II.B.

<sup>360</sup> See *supra* section V.B.4.

adviser will bear it, and there also may be arrangements in which both the adviser and fund will share the expense.<sup>361</sup> Advisers could alternatively attempt to introduce substitute charges (for example, increased management fees) in order to cover the costs of compliance with the rule, but their ability to do so may depend on the willingness of investors to incur those substitute charges.

As discussed below, based on Form ADV filings, as of November 30, 2021, there were 5,037 registered advisers providing advice to private funds, and we estimate that these advisers would, on average, each provide advice to 9 private funds.<sup>362</sup> We further estimate that the audit fee for the required private fund audit would be \$60,000 per fund on average.<sup>363</sup> For purposes of the PRA, the estimated total auditing fees for all funds would therefore be approximately \$2,720 million annually.<sup>364</sup> We further anticipate that the audit requirement would impose for all funds approximately 92,479.32 hours of internal annual burden hours and a cost of approximately \$27.6 million for internal time.<sup>365</sup> However, some funds would obtain the required financial statement audits in the absence of the proposal. The cost of the proposed audit requirement would therefore depend on the extent to which funds currently receive audits and, if so, whether their auditors are registered with the PCAOB.

For example, all or a portion of the costs described in this section may be disproportionately borne by advisers or investors (or both) to securitized asset funds,<sup>366</sup> given that fewer securitized asset funds currently undergo financial statement audits than other categories of funds.<sup>367</sup> We believe that the costs incurred may approximate 10% of these amounts, because across all types of funds, approximately 90% of funds are currently audited in connection with the fund adviser's alternative compliance under the custody rule.<sup>368</sup> However, because a large portion of

funds who do not currently undergo financial statement audits are securitized asset funds, to the extent that audits for securitized asset funds are more costly than for other fund types (for example, if it is more burdensome to audit financial statements that primarily contain securitized assets), then the costs of the proposal may be greater than 10% of the amounts described above.

For advisers that had been complying with the surprise examination requirement of the custody rule and do not have other clients (*e.g.*, separately managed accounts) for which a surprise exam must be obtained, the costs of the audit performed in accordance with the proposed audit rule would be offset by the reduction in costs from no longer obtaining a surprise examination. To the extent that audits cost more than surprise examinations, the offset may be only partial, and to the extent that an adviser must continue to undergo a surprise examination because it has custody of non-private fund client funds and securities, there likely would be no offset. For funds that had received an audit by an auditor that is not registered with the PCAOB, the costs of the audit performed in accordance with the proposed audit rule would also be offset by the reduction in costs from no longer obtaining their previous audit, although we anticipate that the cost of the required audit would likely be greater because a PCAOB-registered and -inspected auditor may cost more than an auditor that is not subject to the same level of PCAOB oversight.

We also understand that the PCAOB registration and inspection requirement may limit the pool of auditors that are eligible to perform these services which could, in turn, increase costs, as a result of the potential for these auditors to charge higher prices for their services. The increase in demand for these services, however, may be limited in light of the high percentage of funds already being audited.<sup>369</sup> The Commission notification requirement of the proposed audit rule would represent a new cost, regardless of whether their private fund clients are already undergoing a financial statement audit. We anticipate that accounting firms would increase their fees as a result of this new obligation and perceived liability. For advisers who had been undergoing a surprise examination for purposes of the custody rule, there may not be as great of an increase in costs in light of similar requirements in

connection with those examinations under that rule.

The indirect costs of the independent audit requirement would depend on the quality of the financial statements of the funds newly subject to audits. These costs may be relatively higher for the funds with lower quality financial statements (*i.e.*, the funds with the greatest benefit from the audit requirement). The indirect costs from the independent audit requirement may include costs of changing the fund's internal financial reporting practices, such as improvements to internal controls over financial reporting, to avoid potential harm to investors from a misstatement. Further, we understand that the requirement to have the auditor registered with, and subject to the regular inspection by, the PCAOB may limit the pool of accountants that are eligible to perform these services because only those accountants that conduct public company issuer audits are subject to regular inspection by the PCAOB.<sup>370</sup> The resulting competition for these services might generally lead to an increase in their costs, as an effect of the proposal.

Costs would also be incurred related to obtaining the required fairness opinion and material business relationship summary in the case of an adviser-led secondary transaction. For purposes of the PRA, we estimate that 10% of advisers providing advice to private funds conduct an adviser-led secondary transaction each year and that the funds would pay external costs of \$40,849 for each fairness opinion and material business relationship summary.<sup>371</sup> Because only approximately 10 percent of advisers conduct an adviser-led secondary transaction each year, the estimated total fees for all funds per year would therefore be approximately \$20.6 million.<sup>372</sup> Further, as discussed in section VI.D below, we anticipate that the fairness opinion and material business relationship summary requirements would impose approximately 3,528 hours of internal

<sup>361</sup> See *infra* section VI.C.

<sup>362</sup> See *infra* section VI.C.

<sup>363</sup> See *infra* footnote 420. The audit fee for an individual fund may be higher or lower than this estimate, with individual fund audit fees varying according to fund characteristics, such as the jurisdiction of the assets, complexity of the holdings, the firm providing the services, and economies of scales.

<sup>364</sup> See *infra* section VI.C.

<sup>365</sup> *Id.*

<sup>366</sup> As noted above, to the extent not prohibited, we expect that in some instances, the fund will bear the audit expense, in others the adviser will bear it, and there also may be arrangements in which both the adviser and fund will share the expense.

<sup>367</sup> See *supra* section V.B.4.

<sup>368</sup> *Id.*

<sup>369</sup> *Id.*

<sup>370</sup> The Sarbanes-Oxley Act authorizes the PCAOB to inspect registered firms for the purpose of assessing compliance with certain laws, rules, and professional standards in connection with a firm's audit work for public company and broker-dealer clients. However, the PCAOB currently has only a temporary inspection program for broker-dealer clients.

<sup>371</sup> See *infra* section VI.D; footnote 430. The fairness opinion fee for an individual fund may be higher or lower than this estimate, with individual fund audit fees varying according to the complexity, terms, and size of the adviser-led secondary transaction, as well as the nature of the assets of the fund.

<sup>372</sup> See *supra* section II.C; see also *infra* section VI.D.

annual burden hours and a cost of approximately \$1,219,499 for internal time annually.<sup>373</sup> These costs will be borne primarily, though not exclusively, by closed-end funds determined to be illiquid funds,<sup>374</sup> as these are the funds that most frequently have the adviser-led secondaries considered by the rule. To the extent that certain hedge fund transactions are captured by the rule, these funds and their investors would also face comparable fees and costs.

The costs associated with obtaining fairness opinions could dissuade some private fund advisers from leading these transactions, which could decrease liquidity opportunities for some private fund advisers. Under current practice, some investors bear the expense associated with obtaining a fairness opinion if there is one. To the extent not prohibited, we expect similar arrangements may be made going forward to comply with the proposed rule. Advisers could alternatively attempt to introduce substitute charges (for example, increased management fees) in order to cover the costs of compliance with the rule, but their ability to do so may depend on the willingness of investors to incur those substitute charges.

In addition, the required documentation of the annual review of the fund compliance program has direct costs that include the cost of legal services associated with the preparation of such documentation. As discussed below, for purposes of the PRA, we anticipate that the requirement for all SEC-registered advisers to document the annual review of their compliance policies and procedures in writing would, for all advisers, impose 44,496 hours of internal annual burden hours at a cost of approximately \$18.9 million for internal time, and approximately \$4.1 million for external costs.<sup>375</sup>

##### 5. Recordkeeping

Finally, the proposed amendment to the recordkeeping rule would require advisers who are registered or required to be registered to retain books and records related to the proposed quarterly statement rule,<sup>376</sup> to retain books and records related to the mandatory adviser audit rule,<sup>377</sup> to support their compliance with the proposed adviser-led secondaries rule,<sup>378</sup> and to support their compliance with the proposed preferential treatment

disclosure rule.<sup>379</sup> The benefit to investors would be to enable an examiner to verify more easily that a fund is in compliance with these proposed rules and to facilitate the more timely detection and remediation of non-compliance. These requirements would also help facilitate the Commission's enforcement and examination capabilities. Also beneficial to investors, advisers may react to the enhanced ability of third parties to detect and impose sanctions against non-compliance due to the recordkeeping requirements by taking more care to comply with the substance of the rule.

These requirements would impose costs on advisers related to maintaining these records. As discussed below, for purposes of the PRA, we anticipate that the additional recordkeeping obligations would impose, for all advisers, 40,800 hours of internal annual burden hours and that the annual cost would be approximately \$2.8 million.<sup>380</sup>

##### *D. Effects on Efficiency, Competition, and Capital Formation*

###### 1. Efficiency

The proposed rules would likely enhance economic efficiency by enabling investors more easily to identify funds that align with their preferences over private fund terms, investment strategies, and investment outcomes, and also by causing fund advisers to align their actions more closely with the interests of investors through the elimination of prohibited practices.

First, the proposed rules could increase the usefulness of the information that investors receive from private fund advisers regarding the fees, expenses, and performance of the fund, and regarding the preferential treatment of certain investors of the fund through the more detailed and standardized disclosures discussed above.<sup>381</sup> These enhanced disclosures would provide more information to investors regarding the ability and potential fit of investment advisers, which may improve the quality of the matches that investors make with private funds and investment advisers in terms of fit with investor preferences over private fund terms, investment strategies, and investment outcomes. The enhanced disclosures may also reduce search costs, as investors may be better able to evaluate the funds of an investment adviser based on the information to be

disclosed at the time of the investment and in the quarterly statement.

Regarding preferential treatment, the proposed rules further align fund adviser actions and investor interests by prohibiting certain preferential treatment practices altogether (instead of only requiring disclosure), specifically prohibiting preferential terms regarding liquidity or transparency that have a material, negative impact on investors in the fund or a substantially similar pool of assets.<sup>382</sup> Prohibiting these activities, and prohibiting remaining preferential treatment activities unless disclosure is provided, may eliminate some of the complexity and uncertainty that investors face about the outcomes of their investment choices, further reducing costs investors must undertake to find appropriate matches between their choice of private fund and their preferences over private fund terms, investment strategies, and investment outcomes.

In addition, the proposed rules' requirements for advisers to obtain audits of fund financial statements would enhance investor protection and thereby improve the efficiency of the investment adviser search process. While many proposed disclosure requirements involve disclosures only to current investors, and not prospective investors, the proposed rule's disclosure requirements may enhance efficiency through the tendency of some fund advisers to rely on investors in current funds to be prospective investors in their future funds. For example, when fund advisers raise multiple funds sequentially, current investors can base their decisions on whether to invest in subsequent funds based on the disclosures of the prior funds.<sup>383</sup> As such, improved disclosures can improve the efficiency of investments without directly requiring disclosures to all prospective investors. Investors may therefore face a lower overall cost of searching for, and choosing among, alternative private fund investments.

Lastly, the proposed rules prohibit various activities that represent possible conflicting arrangements between investors and fund advisers. To the extent that investors currently bear costs of searching for fund advisers who do not engage in these arrangements, or bear costs associated with monitoring fund adviser conduct to avoid harm, then prohibiting these activities may lower investors' overall costs of searching for, monitoring, and choosing among alternative private fund

<sup>373</sup> See *infra* section VI.D.

<sup>374</sup> See *supra* section II.C.

<sup>375</sup> See *infra* section VI.F.

<sup>376</sup> See *supra* section II.A.5.

<sup>377</sup> See *supra* section II.B.8.

<sup>378</sup> See *supra* section II.C.1.

<sup>379</sup> See *supra* section II.E.1.

<sup>380</sup> See *infra* section VI.G.

<sup>381</sup> See *supra* section V.C.2, V.C.3.

<sup>382</sup> See *supra* section II.E.

<sup>383</sup> See *supra* section V.B.3.

investments. This may particularly be the case for smaller investors who are currently more frequently harmed by the activities being considered.

There may be losses of efficiency from the proposed rules to prohibit various activities, and from any changes in fund practices in response to the proposed rules, to the extent that investors currently benefit from those activities or incur costs from those changes. For example, investors who currently receive preferential terms that would be prohibited under the proposal may have only invested with their current adviser because they were able to secure preferential terms. With those preferential terms removed, those investors may choose to re-evaluate the match between their choice of adviser and their overall preferences over private fund terms, investment strategy, and investment outcomes. Depending on the results of this re-evaluation, those investors may choose to incur costs of searching for new fund advisers or alternative investments.

## 2. Competition

The proposed rules may also affect competition in the market for private fund investing. As discussed above, private fund adviser fees may currently total in the hundreds of billions of dollars per year.<sup>384</sup> Enhanced competition from additional transparency may lead to lower fees or may direct investor assets to different funds, fund advisers, or other investments.

First, to the extent that the enhanced transparency of certain fees, expenses, and performance of private funds under the proposal may reduce the cost to some investors of comparing private fund investments, then current investors evaluating whether to continue investing in subsequent funds may be more likely to reject future funds raised by their current adviser in favor of the terms of competing funds, including new funds that advisers may offer as alternatives that they would not have offered absent the increased transparency.

To the extent that this heightened transparency encourages advisers to make more substantial disclosures to prospective investors, investors may also be able to obtain more detailed fee and expense and performance data for other prospective fund investments, strengthening the effect of the proposal on competition.<sup>385</sup> Advisers may therefore update the terms that they

offer to investors, or investors may shift their assets to different funds.

Second, because enhanced transparency of preferential treatment will be provided to both current and prospective investors, there may be reduced search costs to all investors seeking to compare funds on the basis of which investors receive preferential treatment. For example, some funds may lose investors who only participated in the fund because of the preferential terms they received. We anticipate that investors withdrawing from a fund because of a loss of preferential treatment would redeploy their capital elsewhere, and so new advisers would have a new pool of investment capital to pursue.

## 3. Capital Formation

We believe the proposed rules would facilitate capital formation by causing advisers to more efficiently manage private fund clients, by prohibiting activities that may currently deter investors from private fund investing because they represent possible conflicting arrangements, and by enabling investors to choose more efficiently among funds and fund advisers. This may reduce the cost of intermediation between investors and portfolio investments. To the extent this occurs, this would lead to enhanced capital formation in the real economy, as portfolio companies would have greater access to the supply of financing from private fund investors. This would contribute to greater capital formation through greater investment into those portfolio companies.

The proposed rules may also enhance capital formation through their competitive effects by inducing new fund advisers to enter private fund markets.<sup>386</sup> To the extent that existing fund advisers reduce their fees in order to compete more effectively, or to the extent that existing pools of capital are redirected to fund advisers who generate enhanced returns for their investors (for example, advisers who generate larger returns, less correlated returns across different investment strategies, or returns with more favorable risk profiles), the competitive effects of the proposal may provide new opportunities for capital allocation and potentially spur new investments.

Similarly, and in addition to lower costs of intermediation between investors and portfolio investments, the proposed rules may directly lower the costs charged by fund advisers to investors by improving transparency over fees and expenses. The proposed

rules may also enhance overall investor returns (for example, as above, larger returns, less correlated returns across different investment strategies, or returns with more favorable risk profiles) by improving transparency over performance information, prohibiting conflicting arrangements, and requiring external financial statement audits and fairness opinions. To the extent these increased investor funds from lower expenses and enhanced returns are redeployed to new investments, there would be further benefits to capital formation.

There may be reduced capital formation associated with the proposed rules to prohibit various activities, to the extent that investors currently benefit from those activities. For example, investors who currently receive preferential terms that would be prohibited under the proposal may withdraw their capital from their existing fund advisers. Those investors may have less total capital to deploy after bearing costs of searching for new investment opportunities, or they may redeploy their capital away from private funds more broadly and into investments with less effective capital formation.

## E. Alternatives Considered

### 1. Alternatives to the Requirement for Private Fund Advisers To Obtain an Annual Audit

First, the Commission could consider broadening the application of this rule to, for example, apply to all advisers to private funds, rather than to only advisers to private funds that are registered or required to be registered. Extending the application of the proposed audit rule to all advisers and in the context of these pooled investment vehicles would increase the benefits of helping investors receive more reliable information from private fund advisers associated with the rule. Investors would, as a result, have greater assurance in both the valuation of fund assets and, because these valuations often serve as the basis for the calculation of the adviser's fees, the fees charged by advisers. However, the extension of the proposed rule to apply to all advisers would likely impose the costs of obtaining audits on smaller funds advised by unregistered advisers. For these types of funds, the cost of obtaining such an audit may be large compared to the value of fund assets and fees and the related value to investors of the required audit, and so this alternative could inhibit entry of new funds, potentially constraining the growth of the private fund market.

<sup>384</sup> *Id.*

<sup>385</sup> See *supra* section V.C.2.

<sup>386</sup> See *supra* section V.D.2.



Second, instead of broadening the proposed audit rule, we could consider narrowing the rule by providing full or partial exemptions. For example, we could exempt smaller funds or we could exempt an adviser from compliance with the rule where an adviser plays no role in valuing the fund's assets, receives little or no compensation for its services, or receives no compensation based on the value of the fund's assets. We could also exempt advisers of hedge funds and other funds determined to be liquid funds. Further, we could provide an exemption for private funds below a certain asset threshold, for funds that have only related person investors, or for funds that are below a minimum asset value or have a limited number of investors.

These exemptions could also be applied in tandem, for example by exempting only advisers to hedge funds and other funds determined to be liquid funds below a certain asset threshold. For each of these categories, we could consider partial instead of full exemptions, for example by requiring an audit only every two (or more) years instead of not requiring any annual audits at all. Further, the benefits of the rule may not be substantial for funds below a minimum asset value, where the cost of obtaining such an audit would be relatively large compared to the value of fund assets and fees that the rule is intended to provide a check on.

We believe, however, that this narrower alternative with the above exemptions to the proposed audit rule would likely not provide the same investor protection benefits. Many of the investor protection benefits discussed above are specifically associated with the general applicability of the proposed audit rule.<sup>387</sup>

Finally, instead of requiring an audit as described in the proposed audit rule, we could consider requiring that advisers provide other means of checking the adviser's valuation of private fund assets. For example, we could consider requiring that an adviser subject to the proposed audit rule provide information to substantiate the adviser's evaluation to its LPAC or, if the fund has no LPAC, then to all, or only significant investors in the fund. We believe that such methods for checking an adviser's methods of valuation would be substantially less expensive to obtain, which could reduce the cost burdens associated with an audit.

However, we believe that these alternatives would likely not accomplish the same investor protection

benefits as the proposal to require an audit. As an immediate matter, limiting the requirement like so would undermine the broader goal of the proposal to standardize information made available to different investors. We believe, more generally, that these checks would not provide the same level of assurance over valuation and, by extension, fees, to fund investors as an audit. As discussed above, we have historically relied on financial statement audits to verify the existence of pooled investment vehicle investments.

## 2. Alternatives to the Requirement To Distribute a Quarterly Statement to Investors Disclosing Certain Information Regarding Costs and Performance

The Commission could also consider requiring that additional and more granular information be provided in the quarterly statements that we are proposing be sent by registered investment advisers to investors in private funds. For example, we could require that these statements include investor-level capital account information, which would provide each investor with means of monitoring capital account levels at regular intervals throughout the year. Because this more specific information would show exactly how fees, expenses, and performance have affected the investor, it could, effectively, further reduce the cost to an investor of monitoring the value of the services the adviser provides to the investor. We believe, however, that requiring capital account information for each investor would substantially increase costs for funds associated with the preparation of these quarterly statements.

We could also, for example, require disclosure of performance information for each portfolio investment. For funds determined to be illiquid funds in particular, we could require advisers to report the IRR for portfolio investments, assuming no leverage, as well as the cash flows for each portfolio investment.<sup>388</sup> Given the cash flows, end investors could compute other performance metrics, such as PME, for themselves. In addition, this information would give investors means

of checking the more general performance information provided in a quarterly statement, and would, further, allow investors to track and evaluate the portfolio investments chosen by an adviser over time. Cash flow disclosures for each portfolio investment would enable an investor to construct measures of performance that address the MOIC's inability to capture the timing of cash flows, avoid the IRR's assumptions on reinvestment rates of early cash flow distributions, and avoid the IRR's sensitivity to cash flows early in the life of the pool.<sup>389</sup> Investors would also be able to compare performance of individual portfolio investments against the compensation and ownership percentage and other data that advisers would be required to disclose for each portfolio investment under the proposal.<sup>390</sup>

While we believe that advisers would have cash flow data for each portfolio investment available in connection with the preparation of the standardized fund performance information required to be reported pursuant to the proposed rule, calculating performance information for each portfolio investment in accordance with the rule could add significant operational burdens and costs, which would vary depending on factors that include the number of portfolio investments held by a private fund. The operational burden and cost would also depend on whether the alternative proposal required both gross and net performance information for each portfolio investment, which would determine whether the information reflected the impact of fund-level fees and expenses on the performance of each portfolio investment. Requiring both gross and net performance information for each portfolio investment would be of greater use to investors, but would come at a higher operational burden and cost, as providing net performance information would require more complex calculations to allocate fund fees and expenses across portfolio investments. Lastly, to the extent that advisers were required to disclose cash flows for each portfolio investment without the impact of fund-level subscription facilities, this calculation may be more burdensome than the single calculation required to

<sup>388</sup> For funds determined to be liquid funds, disclosure of performance information for each portfolio investment may be of comparatively lower incremental benefit to investors, because such funds typically have a much larger number of investments. To the extent that investors' preferences over different liquid funds depend on more fund outcomes than their total return on their aggregate capital contributions, for example a preference for fund advisers with uncorrelated returns across different portfolio investments, then this alternative could provide similar additional benefits.

<sup>389</sup> See *supra* section V.B.3. See, e.g., Robert Harris, Tim Jenkinson and Steven Kaplan, Private Equity Performance: What Do We Know?, 69 (5) *Journal of Finance* 1851 (Mar. 27, 2014), available at <https://onlinelibrary.wiley.com/doi/full/10.1111/jofi.12154>; Steven Kaplan and Antoinette Schoar, Private Equity Performance: Returns, Persistence, and Capital Flows, 60 (5) *Journal of Finance* (Aug. 2005), available at <http://web.mit.edu/aschoar/www/KaplanSchoar2005.pdf>.

<sup>390</sup> See *supra* section II.A.1.b.

<sup>387</sup> See *supra* section V.C.4.

make the required fund-level performance information disclosures without the impact of fund-level subscription facilities.

As a final granular addition to performance disclosures, the Commission could require the reporting of a wider variety of performance metrics for hedge funds and other funds determined to be liquid funds, similar to the detailed disclosure requirements for funds determined to be illiquid funds. These could include requirements for funds determined to be liquid funds to report estimates of fund-level alphas, betas, Sharpe ratios, or other performance metrics. We believe that for investors of funds determined to be liquid funds, absolute returns are of highest priority, and furthermore investors may calculate many of these additional performance metrics themselves by combining fund annual total returns with publicly available data. Therefore, we believe these additional reporting requirements would impose additional costs with comparatively little benefit.

Further, the Commission could also consider requiring less information be provided to investors in these quarterly statements. For example, instead of requiring the disclosure of comprehensive fee and expense information, we could require that advisers disclose only a subset of these, including investments fees and expenses paid by a portfolio company to the adviser. These fees in particular may currently present the biggest burden on investors to track, and requiring the disclosure of only these fees could reduce some costs associated with the effort of compiling, on a quarterly basis, information regarding management fees more generally. We believe, however, that if we did not require comprehensive information, investors would not derive the same utility in monitoring fund performance.

We could also consider requiring that comprehensive information regarding fees and performance be reported on Form ADV, instead of being disclosed to investors individually. Reporting publicly on Form ADV would continue to allow investors to monitor performance, while also allowing public review of important information about an adviser. However, because the information we propose to require under the rule is tailored to what we believe would serve existing investors in a fund, we believe that direct delivery to investors would better reduce monitoring costs for investors. Further, as discussed above, prospective investors have separate protections, including against misleading, deceptive,

and confusing information in advertisements as set forth in the recently adopted marketing rule.<sup>391</sup>

Instead of requiring disclosure of comprehensive fee and expense information to investors, we could consider prohibiting certain fee and expense practices. For example, we could prohibit charging fees at the fund level in excess of a certain maximum amount that we could determine to be what investors could reasonably anticipate being charged by an adviser. This could, effectively, protect investors from unanticipated charges, and reduce monitoring costs to investors. Further, we could prohibit certain compensation arrangements, such as the “2 and 20” model or compensation from portfolio investments, to the extent the adviser also receives management fees from the fund. Prohibition of the “2 and 20” model would cause investors to reallocate their capital away from funds that employ this model and toward other types of funds. It may cause advisers to consider and adopt more efficient models for private fund investing in which the adviser gets a smaller fee and the investor gets a larger share of the gross fund returns, and in which investors are generally better off.<sup>392</sup> We could also consider restricting management fee practices, for example by imposing limitations on sizes of management fees, or requirement management fees to be based on invested capital or net asset value rather than on committed capital. However, the benefits of prohibiting certain fee and expense practices outright would need to be balanced against the costs associated with limiting an adviser and investor’s flexibility in designing fee and expense arrangements tailored to their preferences. We believe that any such prohibitions would, accordingly, need to be carefully tailored.

Similarly, instead of requiring disclosure of comprehensive performance information to investors, we could consider prohibiting certain performance disclosure practices. For example, instead of requiring disclosure of performance without the effect of fund-level subscription facilities, we could consider prohibiting advisers from presenting performance with the

effect of such facilities. Similarly, we could consider prohibiting advisers from presenting combined performance information for multiple funds, such as a main fund and a co-investment fund that pays lower or no fees. We believe that the required disclosures present the correct standardized, detailed information for investors to be able to evaluate performance, but we do not believe there are harms from advisers electing to disclose additional information. As such, we think the benefits of prohibiting any performance disclosure practices would likely be negligible, while there could be substantial costs to investors who value the information that would be prohibited under this alternative.

Finally, the Commission could consider broadening the application of this rule to, for example, apply to all advisers to private funds, rather than to only advisers to private funds that are registered or required to be registered. Extending the application of the proposed rule to all advisers would increase the benefits of helping investors receive more detailed and standardized information regarding fees, expenses, and performance. Investors would, as a result, have better information with which to evaluate the services of these advisers. It is, however, not clear to us that these benefits would also be realized in contexts where fund performance is not as heavily relied upon when obtaining new investors, as is the case for private funds. Further, the extension of the proposed rule to apply to all advisers would likely impose the costs of compiling, preparing, and distributing quarterly statements on smaller funds advised by unregistered advisers. For these types of funds, these quarterly statement costs may be large compared to the value of fund assets and fees and the related value to investors of the required audit.

### 3. Alternative to the Required Manner of Preparing and Distributing Quarterly Statements and Audited Financial Statements

The proposed rules would require private fund advisers to “distribute” quarterly statements and audited annual financial statements to investors in the private fund, and this requirement could be satisfied through either paper or electronic means.<sup>393</sup> The Commission could consider requiring private fund advisers to prepare and distribute the required disclosures electronically using a structured data language, such as the

<sup>391</sup> See *supra* section II.A.2.

<sup>392</sup> For example, the compensation model for hedge funds can provide fund advisers with embedded leverage, encouraging greater risk-taking. See, e.g., Alon Brav, Wei Jiang, and Rongchen Li, Governance by Persuasion: Hedge Fund Activism and Market-Based Shareholder Influence, *European Corporate Governance Institute—Finance* (Working Paper No. 797/2021), available at <https://ssrn.com/abstract=3955116> or <http://dx.doi.org/10.2139/ssrn.3955116>.

<sup>393</sup> See *supra* footnote 99.

Inline eXtensible Business Reporting Language (“Inline XBRL”).

An Inline XBRL requirement for the disclosures could benefit private fund investors with access to XBRL analysis software by enabling them to more efficiently access, compile, and analyze the disclosures in quarterly statements and audited annual financial statements, facilitating calculations and comparisons of the disclosed information across different time periods or across different portfolio investments within the same time period. For any such private fund investors who receive disclosures from multiple private funds, an Inline XBRL requirement could also facilitate comparisons of the disclosed information across those funds.

An Inline XBRL requirement for the proposed disclosures would diverge from the Commission’s other Inline XBRL requirements, which apply to disclosures that are made available to the public and the Commission, thus allowing for the realization of informational benefits (such as increased market efficiency and decreased information asymmetry) through the processing of Inline XBRL disclosures by information intermediaries such as analysts and researchers.<sup>394</sup> Under the current proposal, the required disclosures would not be provided to the public or the Commission for processing and analysis. Thus, the magnitude of benefit resulting from an Inline XBRL alternative for the disclosure requirements in this proposal may be lower than for other rules with Inline XBRL requirements.<sup>395</sup>

Compared to the proposal, an Inline XBRL requirement would result in additional compliance costs for private

funds and advisers, as a result of the requirement to select, apply, and review the appropriate XBRL U.S. GAAP taxonomy element tags for the required disclosures (or pay a third-party service provider to do so on their behalf). In addition, private fund advisers may not have prior experience with preparing Inline XBRL documents, as neither Form PF nor Form ADV is filed using Inline XBRL. Thus, under this alternative, private funds may incur the initial Inline XBRL implementation costs that are often associated with being subject to an Inline XBRL requirement for the first time (including, as applicable, the cost of training in-house staff to prepare filings in Inline XBRL and the cost to license Inline XBRL filing preparation software from vendors). Accordingly, the magnitude of compliance cost resulting from an Inline XBRL requirement under this proposal may be higher than for other rules with Inline XBRL requirements.

#### 4. Alternatives to the Prohibitions From Engaging in Certain Sales Practices, Conflicts of Interest, and Compensation Schemes

The Commission could also consider prohibiting other activities, in addition to those currently prohibited in the proposed rule. For example, we could prohibit advisers from charging private funds for expenses generally understood to be adviser expenses, such as those incurred in connection with the maintenance and operation of the adviser’s business. To the extent that the performance of these activities is outsourced to a consultant, for example, and the fund is charged for that service, advisers may be effectively shifting expenses that would be generally recognized as adviser expenses to instead be fund expenses. The prohibition of such charges could reduce investor monitoring costs. We believe, however, that identifying the types of charges associated with activities that should never be charged to the fund would likely be difficult. As a result, any such prohibition could risk effectively limiting an adviser’s ability to outsource certain activities that could be better performed by a consultant, because under the prohibition the adviser would not be able to pass those costs on to the fund.

Further, the Commission could consider providing an exemption for funds utilizing a pass-through expense model from the prohibition on charging fees or expenses associated with certain examinations, investigations, and regulatory and compliance fees and expenses. This would allow advisers to avoid the costs associated with re-

structuring any arrangements not compliant with the prohibition, given the proposed rules would likely prohibit certain aspects of these expense models.<sup>396</sup> We believe, however, that any exemption would need to be carefully balanced against the risk that it would continue to subject the fund to an adviser’s incentive to shift its fees and expenses to the fund to reduce its overhead and operating costs.

We could also consider requiring detailed and standardized disclosures of the activities under consideration, instead of prohibiting the activities outright. This alternative may be desirable to the extent that certain investors would be willing to bear the costs of these activities in exchange for certain other beneficial terms, and would be willing to give informed consent to fund advisers engaging in the practices under consideration. However, we do not believe that disclosure requirements would achieve the same benefit of protecting investors from harm, because many of the practices are deceptive and result in obscured payments, and so may be used to defraud investors even if detailed disclosures are made. Moreover, as discussed above, private funds typically lack fully independent governance mechanisms more common to other markets that could help protect investors from harm in the context of the activities considered.<sup>397</sup>

We could, therefore, consider exceptions that allow certain prohibited activities if disclosed and if appropriate governance or other protections are in place. For example, we could consider requiring a fund’s LPAC (or other similar body) or directors to give approval to any of the activities under consideration before the adviser may pursue them. Similarly, we could require advisers to obtain approval for any of the activities under consideration by a majority (either by number or by interest) of investors. However, we believe that allowing such activities, even under such governance, would not achieve all of the same benefits of protecting investors, by the same logic that many of the practices are deceptive and result in obscured payments, and so may be used to defraud investors even if disclosed and governed.

#### 5. Alternatives to the Requirement That an Adviser To Obtain a Fairness Opinion in Connection With Certain Adviser-Led Secondary Transactions

The Commission could consider requiring advisers to obtain a third party

<sup>394</sup> See, e.g., Y. Cong, J. Hao, and L. Zou, *The Impact of XBRL Reporting on Market Efficiency*, 28 *J. Info. Sys.* 181 (2014) (finding support for the hypothesis that “XBRL reporting facilitates the generation and infusion of idiosyncratic information into the market and thus improves market efficiency”); Y. Huang, J.T. Parwada, Y.G. Shan, and J. Yang, *Insider Profitability and Public Information: Evidence From the XBRL Mandate* (Working Paper, 2019) (finding XBRL adoption levels the informational playing field between insiders and non-insiders).

<sup>395</sup> See, e.g., *Updated Disclosure Requirements and Summary Prospectus for Variable Annuity and Variable Life Insurance Contracts*, Release No. IC-33814 (Mar. 11, 2020) [85 FR 25964 at 26041 (Jun. 10, 2020)] (Noting that an Inline XBRL requirement for certain variable contract prospectus disclosures, which are publicly available, would include informational benefits stemming from use of the Inline XBRL data by parties other than investors, including financial analysts, data aggregators, and Commission staff. While the required disclosures in this proposal would not be provided to the public or the Commission, such benefits would not accrue from an Inline XBRL requirement for the required disclosures).

<sup>396</sup> See *supra* section V.C.3.

<sup>397</sup> See *supra* section V.B.1.

valuation in connection with certain adviser-led secondary transactions, instead of a fairness opinion. We believe that these third party valuations would likely involve more diligence of the proposed transaction than the reviews conducted in connection with obtaining a fairness opinion, and therefore, requiring these valuations could provide even greater assurances to investors that the terms of the transaction are fair to their interests. However, we believe that obtaining a third-party valuation would likely be significantly more costly to obtain. If these costs could be passed on to participants in these transactions, it could make them less attractive to investors as a means to obtain liquidity.

We could also consider changing the scope of this rule. For example, we could consider broadening the application of this rule to, for example, apply to all advisers, including advisers that are not required to register as investment advisers with the Commission, such as state-registered advisers and exempt reporting advisers. Investors would, as a result, receive the assurance of the fairness of more adviser-led secondary transactions. The extension of the proposed rule to apply to all advisers would, however, likely impose the costs of obtaining fairness opinions on smaller funds advised by unregistered advisers, and for these types of funds, the cost of obtaining such opinions would likely be relatively large compared to the value of fund assets and fees that the rule is intended to provide a check on, which could discourage them from undertaking these transactions. This could ultimately reduce liquidity opportunities for fund investors. Alternatively, we could provide exemptions from the rule. For example, an exemption could be provided where the adviser undertakes a competitive sale process for the assets being sold or for certain advisers to hedge funds or other funds determined to be liquid funds for whom the concerns regarding pricing of illiquid assets may be less relevant. These exemptions would reduce the costs on advisers associated with obtaining the fairness opinion, which could ultimately reduce costs for investors. However, we believe that any such exemptions could reduce the benefits of the proposed rule associated with providing greater assurance to investors of the fairness of the transaction. We believe that, even under circumstances where the adviser has conducted a competitive sales process, the effective check on this process provided by the fairness opinion would benefit investors. Further, even for advisers to

hedge funds or other funds determined to be liquid funds who are advising funds with predominantly highly liquid securities, we believe that a fairness opinion would be beneficial to investors because the conflicts of interest inherent in structuring and leading a transaction may, despite the nature of the assets in the fund, harm investors.<sup>398</sup>

#### 6. Alternatives to the Prohibition From Providing Certain Preferential Terms and Requirement To Disclose All Preferential Treatment

Instead of requiring that private fund advisers provide investors and prospective investors with written disclosures regarding all preferential treatment the adviser or its related persons provided to other investors in the same fund, the Commission could consider prohibiting all such terms. This could provide investors in private funds with increased confidence that the adviser's negotiations with other investors would not affect their investment in the private fund. We preliminarily believe, however, that an outright prohibition of all preferential terms may not provide significant additional benefits beyond prohibitions on providing certain preferential terms regarding redemption or information about portfolio holdings or exposures. As discussed above, we believe that certain types of preferential terms raise relatively few concerns, if disclosed.<sup>399</sup> Further, an outright prohibition of all preferential terms may limit the adviser's ability to respond to an individual investor's concerns during the course of attracting capital investments to private funds.

Further, we could consider prohibiting *all* preferential terms regarding redemption or information about portfolio holdings or exposures, rather than just those that the adviser reasonably expects to have a material, negative effect on other investors in that fund or in a substantially similar pool of assets. This could increase the investor protections associated with the rule, by eliminating the risk that a term not reasonably expected to have a material negative effect on investors could, ultimately, harm investors. We believe, however, that this alternative would likely provide more limited benefits and would increase costs associated with the rule similar to the above alternatives, for example by limiting the adviser's ability to respond to an individual investor's concerns

during the course of attracting capital investments to private funds.

In addition, for preferential terms not regarding redemption or information about portfolio holdings or exposures, we could consider requiring advisers to private funds to provide disclosure only when the term has a material negative effect on other fund investors. This could reduce the compliance burden on advisers associated with the costs of disclosure. We believe, however, that limiting disclosure to only those terms that an adviser determines to have a material negative effect could reduce an investor's ability to recognize the potential for harm from unforeseen favoritism toward other investors, relative to a requirement to disclose all preferential treatment.

#### F. Request for Comment

The Commission requests comment on all aspects of the economic analysis of the proposed rule. To the extent possible, the Commission requests that commenters provide supporting data and analysis with respect to the benefits, costs, and effects on competition, efficiency, and capital formation of adopting the proposed amendments or any reasonable alternatives. In particular, the Commission asks commenters to consider the following questions:

- What additional qualitative or quantitative information should the Commission consider as part of the baseline for its economic analysis of these amendments?
- Has the Commission accurately characterized the costs and benefits of proposed rule? If not, why not? Should any of the costs or benefits be modified? What, if any, other costs or benefits should the Commission take into account? If possible, please offer ways of estimating these costs and benefits. What additional considerations can the Commission use to estimate the costs and benefits of the proposed amendments?
- Has the Commission accurately characterized the effects on competition, efficiency, and capital formation arising from the proposed rules? If not, why not?
- Has the Commission accurately characterized the economic effects of the above alternatives? If not, why not? Should any of the costs or benefits be modified? What, if any, other costs or benefits should the Commission take into account? Are there other reasonable alternatives to the proposed amendments? What are the economic effects of any other alternatives?
- Are there data sources or data sets that can help the Commission refine its

<sup>398</sup> Moreover, the costs to liquid fund advisers are more likely to be limited, as many secondary transactions by liquid fund advisers are not adviser-led and so would not necessitate a fairness opinion.

<sup>399</sup> See *supra* section II.E.

estimates of the costs and benefits associated with the proposed amendments? If so, please identify them.

- How would the proposed delivery of the quarterly statement affect the reporting practices of advisers, including the costs and benefits of these statements? Would advisers add the required report to the report that they currently provide to investors? Would advisers substitute the required report for an existing report? Explain.

- What are the benefits to investors of obtaining the information that would be required under the proposal in a standardized format that would enable them to make comparisons across alternative fund investments? Explain. Would the benefits to investors vary based on the investor's scale of operations, relationship with the adviser, or other factors? Explain. Please provide data, if available, to support your answer along with details regarding data sources and interpretation of statistics, where appropriate.

- Would the proposed rules strengthen the bargaining power of investors in negotiating with private fund advisers? If so, under what circumstances, and for what types of funds and investors would this effect occur? How would it affect other investors who do not gain bargaining power as a result of the proposed rules? Please explain your answer and provide supporting data, if possible.

- What would the aggregate total cost (including but not limited to the audit fee) be of complying with the new audit requirement, separately, for (a) funds that currently receive audits and (b) funds that would newly receive an audit under the proposed rule? For each, what is the current per-fund cost of an audit? Is the per-fund cost different between the funds that currently receive audits and would newly receive audits? If yes, explain. Please include an explanation of any differences between the funds that currently receive an audit and the funds that would newly receive an audit that would explain the differences in their per-fund audit costs. Provide quantitative evidence to support your explanation, if available.

- Would the proposed rules introduce new fixed costs of compliance? Would they cause private funds or fund advisers to consolidate their operations to economize on those costs? Please explain. Provide quantitative evidence to support your explanation, if available.

- To what extent do funds currently provide quarterly statements to investors, and what is the cost of

providing these statements? How are they delivered? How do investors use them? What are the contents of these statements currently? How do the current contents compare with the contents that would be required under the proposed rule? Explain.

- We believe that the information in the new quarterly statements would supplement the information that investors currently receive about their fund investments and that advisers would not respond to the proposal by discontinuing any reports to investors. Is this correct? Why or why not? Please explain.

- What fee and expense information is currently available to investors for use in comparing investment opportunities among similar funds (sponsored by the same adviser or different advisers)? How does this information differ from the information that advisers would be required to provide under the proposed rule? In what way does the lack of this information affect investor choice or the ability of investors to monitor fund performance net of fees and expenses?

- What performance information is currently available for investors for use in comparing investment opportunities among similar funds (sponsored by the same adviser or different advisers)? How does this information differ from the information that advisers would be required to provide under the proposed rule?

- How frequently do advisers currently engage in each of the activities that would be prohibited under the proposed rule? Does this frequency vary depending on the type of adviser or investor? For each practice, what is the current business purpose of the activity and how else might that purpose be achieved (if the activity were prohibited)? Please provide quantitative evidence on the magnitude of the activity, *e.g.*, how much money do advisers and related persons receive from the fee and expense arrangements that would be prohibited?

- What is the economic effect on investors, currently, of the activities we propose to prohibit under the proposed rule? What empirical evidence is there that those activities make investors worse off?

- What data exists regarding the costs to investors of conflicts of interest in connection with adviser-led secondary transactions where an adviser offers fund investors the option to sell their interests in the private fund, or to exchange them for new interests in another vehicle advised by the adviser? How do costs vary according to the presence or absence of the disclosure

that would be required under the proposed rule?

- From what sources do investors receive information about fund performance: (a) When comparing alternative prospective fund investments and (b) for evaluating the performance of an ongoing und investment? For example, do investors obtain this information directly from the advisers or from a third party? If from a third party, from what source does the third party obtain the fund performance information, and what is the cost of this information? How does the source vary with the fund type or third party, if at all?

- How frequently and under what conditions are private fund investors (current and prospective) unable to obtain information from fund advisers or third parties on the fund performance?

- Do investors rely on IRR and MOIC for evaluating the performance of funds determined to be illiquid funds? What additional information do investors use to evaluate illiquid fund performance? How frequently do they rely on this information? From what sources do they currently obtain this information?

- How do investors who do not have access to this information evaluate illiquid fund performance? What alternative sources of information do they rely upon?

- Do investors rely on annual total returns for evaluating the performance of funds determined to be liquid funds? When evaluating performance partway through a current year, do investors rely on cumulative total return for the current calendar year? What additional information do investors use to evaluate liquid fund performance? How frequently do they rely on this information? From what sources do they currently obtain this information?

- How do investors who do not have access to this information evaluate liquid fund performance? What alternative sources of information do they rely upon?

## VI. Paperwork Reduction Act

### A. Introduction

Certain provisions of our proposal would result in new “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).<sup>400</sup> The proposed amendments would also have an impact on the current collection of information burdens of rules 206(4)–7 and 204–2 under the Advisers Act. The title of the new collection of information

<sup>400</sup> 44 U.S.C. 3501 *et seq.*

requirements we are proposing are “Rule 211(h)(1)–2 under the Advisers Act,” “Rule 206(4)–10 under the Advisers Act,” “Rule 211(h)(2)–2 under the Advisers Act,” and “Rule 211(h)(2)–3 under the Advisers Act.” The Office of Management and Budget (“OMB”) has not yet assigned control numbers for these new collections of information. The titles for the existing collections of information that we are proposing to amend are: (i) “Rule 206(4)–7 under the Advisers Act (17 CFR 275.206(4)–7)” (OMB control number 3235–0585) and (ii) “Rule 204–2 under the Advisers Act (17 CFR 275.204–2)” (OMB control number 3235–0278). The Commission is submitting these collections of information to OMB for review and approval in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

We discuss below the new collection of information burdens associated with new rules 211(h)(1)–2, 206(4)–10, 211(h)(2)–2, and 211(h)(2)–3 as well as the revised existing collection of information burdens associated with the proposed amendments to rules 206(4)–7 and 204–2. Responses provided to the Commission in the context of amendments to rules 206(4)–7 and 204–2 would be kept confidential subject to the provisions of applicable law. Because the information collected pursuant to new rules 211(h)(1)–2, 211(h)(2)–2, and 211(h)(2)–3 requires disclosures to existing investors and in some cases potential investors, these disclosures would not be kept confidential. Proposed new rule 206(4)–10 requires the collection of two types of information: one type (the audited

financial statements) would be distributed only to investors in the private fund, and the other (notifications to the Commission) would be kept confidential subject to the provisions of applicable law.

#### *B. Quarterly Statements*

Proposed rule 211(h)(1)–2 would require an investment adviser registered or required to be registered with the Commission to prepare a quarterly statement that includes certain standardized disclosures regarding the cost of investing in the private fund and the private fund’s performance for any private fund that it advises, directly or indirectly, that has at least two full calendar quarters of operating results, and distribute the quarterly statement to the private fund’s investors within 45 days after each calendar quarter end, unless such a quarterly statement is prepared and distributed by another person.<sup>401</sup> The quarterly statement would provide investors with fee and expense disclosure for the prior quarterly period or, in the case of a newly formed private fund initial account statement, its first two full calendar quarters of operating results. It would also provide investors with certain performance information depending on whether the fund is categorized as a liquid fund or an illiquid fund.<sup>402</sup>

The collection of information is necessary to provide private fund investors with information about their private fund investments. The quarterly statement would allow a private fund investor to compare standardized cost and performance information across its private fund investments. We believe this information would help inform investment decisions, including whether to remain invested in certain private funds or to invest in other

private funds managed by the adviser or its related persons. More broadly, this disclosure would help inform investors about the cost and performance dynamics of this marketplace and potentially improve efficiency for future investments.

Each requirement to disclose information, offer to provide information, or adopt policies and procedures constitutes a “collection of information” requirement under the PRA. This collection of information is found at 17 CFR 275.211(h)(1)–2 and is mandatory. The respondents to these collections of information requirements would be investment advisers that are registered or required to be registered with the Commission that advise one or more private funds.

Based on Investment Adviser Registration Depository (IARD) data, as of November 30, 2021, there were 14,832 investment advisers registered with the Commission. According to this data, 5,037 registered advisers provide advice to private funds.<sup>403</sup> We estimate that these advisers would, on average, each provide advice to 9 private funds.<sup>404</sup> We further estimate that these private funds would, on average, each have a total of 67 investors.<sup>405</sup> As a result, an average private fund adviser would have, on average, a total of 603 investors across all private funds it advises. As noted above, because the information collected pursuant to proposed rule 211(h)(1)–2 requires disclosures to private fund investors, these disclosures would not be kept confidential.

We have made certain estimates of this data solely for the purpose of this PRA analysis. The table below summarizes the initial and ongoing annual burden estimates associated with the proposed account statement rule.

TABLE 1—RULE 211(h)(1)–2 PRA ESTIMATES

	Internal initial burden hours	Internal annual burden hours	Wage rate <sup>1</sup>	Internal time cost	Annual external cost burden
<b>PROPOSED ESTIMATES</b>					
Preparation of account statements.	9	11 hours <sup>2</sup> .....	\$382 (blended rate for compliance attorney (\$373), assistant general counsel (\$476), and financial reporting manager (\$297)).	\$4,202 .....	\$4,030. <sup>3</sup>
Distribution of account statements to existing investors.	1.5	3.5 hours <sup>4</sup> .....	\$64 (rate for general clerk) .....	\$224 .....	\$930. <sup>5</sup>

<sup>401</sup> See proposed rule 211(h)(1)–2.

<sup>402</sup> See proposed rule 211(h)(1)–2(d).

<sup>403</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1).

<sup>404</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1).

<sup>405</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1).A., #13.

TABLE 1—RULE 211(h)(1)–2 PRA ESTIMATES—Continued

	Internal initial burden hours	Internal annual burden hours	Wage rate <sup>1</sup>	Internal time cost	Annual external cost burden
Total new annual burden per private fund.		14.5 hours .....	.....	\$4,426 .....	\$4,960.
Avg. number of private funds per adviser.		9 private funds .....	.....	9 private funds .....	9 private funds.
Number of PF advisers.		5,037 advisers .....	.....	5,037 advisers .....	2,518. <sup>6</sup>
Total new annual burden.		657,328.5 hours .....	.....	\$200,643,858 .....	\$112,403,250.

**Notes:**

<sup>1</sup> The Commission's estimates of the relevant wage rates are based on salary information for the securities industry compiled by the Securities Industry and Financial Markets Association's Office Salaries in the Securities Industry 2013. The estimated figures are modified by firm size, employee benefits, overhead, and adjusted to account for the effects of inflation. See Securities Industry and Financial Markets Association, Report on Management & Professional Earnings in the Securities Industry 2013 ("SIFMA Report").

<sup>2</sup> This includes the internal initial burden estimate annualized over a three-year period, plus 8 hours of ongoing annual burden hours and takes into account that there would be four statements prepared each year. The estimate of 11 hours is based on the following calculation: ((9 initial hours/3 years) + 8 hours of additional ongoing burden hours) = 11 hours.

<sup>3</sup> This estimated burden is based on the sum of the estimated wage rate of \$496/hour, for 5 hours, (\$2,480) for outside legal services and the estimated wage rate of \$310/hour, for 5 hours, (\$1,550) for outside accountant assistance, and it assumes that there would be four statements prepared each year. The Commission's estimates of the relevant wage rates for external time costs, such as outside legal services, takes into account staff experience, a variety of sources including general information websites, and adjustments for inflation.

<sup>4</sup> This includes the internal initial burden estimate annualized over a three-year period, plus 3 hours of ongoing annual burden hours that takes into account that there would be four statements prepared each year. The estimate of 3.5 hours is based on the following calculation: ((1.5 initial hours/3 years) + 3 hours of additional ongoing burden hours) = 3.5 hours.

<sup>5</sup> This estimated burden is based on the estimated wage rate of \$310/hour, for 3 hours, for outside accounting services, and it assumes that there would be four statements distributed each year. See *supra* footnote 409 (regarding wage rates with respect to external cost estimates).

<sup>6</sup> We estimate that 50% of advisers will use outside legal and accounting services for these collections of information. This estimate takes into account that advisers may elect to use outside these services (along with in-house counsel), based on factors such as adviser budget and the adviser's standard practices for using such outside services, as well as personnel availability and expertise.

### C. Mandatory Private Fund Adviser Audits

Proposed rule 206(4)–10 would require investment advisers that are registered or required to be registered to cause each private fund they advise, directly or indirectly, to undergo a financial statement audit at least annually and upon liquidation that complies with the proposed rule, unless the fund otherwise undergoes such an audit.<sup>406</sup> We believe that proposed new rule 206(4)–10 would protect the fund and its investors against the misappropriation of fund assets and that an audit performed by an independent public accountant would provide an important check on the adviser's valuation of private fund assets, which often serve as the basis for the calculation of the adviser's fees. The collection of information is necessary to provide private fund investors with information about their private fund investments and the Commission uses

this information in the context of its examination and oversight program.

Each requirement to disclose information, offer to provide information, or adopt policies and procedures constitutes a "collection of information" requirement under the PRA. This collection of information is found at 17 CFR 275.206(4)–10 and is mandatory to the extent the adviser provides investment advice to a private fund. The respondents to these collections of information requirements would be investment advisers that are registered or required to be registered with the Commission that advise one or more private funds. All responses required by the proposed audit rule would be mandatory. One response type (the audited financial statements) would be distributed only to investors in the private fund and would not be confidential, and the other (notifications to the Commission) would be kept confidential subject to the provisions of applicable law.

Based on IARD data, as of November 30, 2021, there were 14,832 investment advisers registered with the Commission. According to this data, 5,037 registered advisers provide advice to private funds.<sup>407</sup> We estimate that these advisers would, on average, each provide advice to 9 private funds.<sup>408</sup> We further estimate that these private funds would, on average, each have a total of 67 investors.<sup>409</sup> As a result, an average private fund adviser would have, on average, a total of 603 investors across all private funds it advises.

We have made certain estimates of this data, as discussed below, solely for the purpose of this PRA analysis. The table below summarizes the initial and ongoing annual burden estimates associated with the proposed rule's reporting requirement.

<sup>407</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1).

<sup>408</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1).

<sup>409</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1).A., #13.

<sup>406</sup> See proposed rule 206(4)–10.



TABLE 2—RULE 206(4)–10 PRA ESTIMATES

	Internal initial burden hours	Internal annual burden hours	Wage rate <sup>1</sup>	Internal time cost	Annual external cost burden
<b>PROPOSED ESTIMATES</b>					
Distribution of audited financial statements <sup>2</sup> .	0	1.12 hours <sup>3</sup> .....	\$153.33 (blended rate for intermediate accountant (\$175), general accounting supervisor (\$221), and general clerk (\$64)).	\$171.73 .....	\$60,000. <sup>4</sup>
Preparation of the written agreement <sup>5</sup> .	<sup>6</sup> 1.25	0.92 hours <sup>7</sup> .....	\$476 (rate for assistant general counsel)	\$437.92 .....	\$0.
Total new annual burden per private fund.		2.04 hours .....	.....	\$609.65 .....	\$60,000. <sup>8</sup>
Avg. number of private funds per adviser.		9 private funds .....	.....	9 private funds .....	9 private funds.
Number of advisers		5,037 advisers .....	.....	5,037 advisers .....	5,037 advisers.
Total new annual burden.		92,479.32 hours .....	.....	\$27,637,263.40 .....	\$2,719,980,000.

**Notes:**

1. See SIFMA Report *supra* Note 1 to Table 1 Rule 211(h)(1)–2 PRA Estimates.

2. The proposed audit provision would require an adviser to obtain an audit at least annually and upon an entity's liquidation. To the extent not prohibited, we anticipate that, in some cases, the fund will bear the audit expense, in other cases the adviser will bear it, and in other instances both the adviser and fund will share the expense. The liquidation audit would serve as the annual audit for the fiscal year in which it occurs. See proposed rule 206(4)–10.

3. This estimate takes into account that the financial statements must be distributed once annually under the proposed audit rule and that a liquidation audit would replace a final audit in a year. Based on our experience with similar requirements under the custody rule, we estimate the hour burden imposed on the adviser relating to the distribution of the audited financial statements with respect to the investors in each fund should be minimal, approximately one minute per investor. See *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2968 (Dec. 30, 2009) [75 FR 1455 (Jan. 11, 2010)] (“Custody Rule 2009 Adopting Release”), at 59–60. We estimate that the average private fund has 67 investors.

4. Based on our experience, we estimate that the party (or parties) that bears the audit expense would pay an average audit fee of \$60,000 per fund. We estimate that individual fund audit fees would tend to vary over an estimated range from \$15,000 to \$300,000, and that some fund audit fees would be higher or lower than this range. We understand that the price of the audit has many variables, such as whether it is a liquid fund or illiquid fund, the number of its holdings, availability of a PCAOB-registered and -inspected auditor, economies of scale, and the location and size of the auditor.

5. The proposed rule would require the adviser or the private fund to enter into an agreement with the independent public accountant. The agreement would require the independent public accountant that completes the audit to notify the Commission by electronic means directed to the Division of Examinations promptly upon certain events. See proposed rule 206(4)–10(e).

6. For purposes of this PRA we assume that, regardless of whether the adviser or the fund enters into the written agreement, the accountant would incur the hour burden of preparing the agreement. We also assume that, if the fund was party to the agreement, the fund would delegate the task of reviewing the agreement to the adviser. This estimate also assumes that the adviser would enter into a separate agreement for each private fund, even if multiple funds use the same auditor. We believe that written agreements are commonplace and reflect industry practice when a person retains the services of a professional such as an accountant, and they are typically prepared by the accountant in advance. We therefore estimate that each adviser would spend 1.25 hours to add the required provisions to, or confirm that the required provisions are in, the written agreement.

7. This includes the internal initial burden estimate annualized over a three-year period, plus 0.5 hours of ongoing annual burden hours, and it assumes annual reassessment and execution: ((1.25 initial hours/3 years) + 0.5 hours of additional ongoing burden hours) = 0.92 hours.

8. We assume the same frequency of these cost estimates as for the internal annual burden hours estimate.

**D. Adviser-Led Secondaries**

Proposed rule 211(h)(2)–2 would prohibit an adviser registered or required to be registered from completing an adviser-led secondary transaction with respect to any private fund, unless the adviser, prior to the closing of the transaction, distributes to investors in the private fund a fairness opinion from an independent opinion provider and a summary of any material business relationships the adviser or any of its related persons has, or has had within the past two years, with the independent opinion provider.<sup>410</sup> We believe that this proposed requirement

would provide an important check against an adviser's conflicts of interest in structuring and leading a transaction from which it may stand to profit at the expense of private fund investors and would help ensure that private fund investors are offered a fair price for their private fund interests. Specifically, this requirement is designed to help ensure that investors receive the benefit of an independent price assessment, which we believe will improve their decision-making ability and their overall confidence in the transaction. The collection of information is necessary to provide investors with information about securities transactions in which they may engage.

Each requirement to disclose information, offer to provide information, or adopt policies and procedures constitutes a “collection of information” requirement under the PRA. This collection of information is found at 17 CFR 275.211(h)(2)–2 and is mandatory. The respondents to these collections of information requirements would be investment advisers that are registered or required to be registered with the Commission that advise one or more private funds. Based on IARD data, as of November 30, 2021, there were 14,832 investment advisers registered with the Commission. According to this data, 5,037 registered advisers provide advice to private

<sup>410</sup> See proposed rule 211(h)(2)–2.

funds.<sup>411</sup> Of these 5,037 advisers, we estimate that 10%, or approximately 504 advisers, conduct an adviser-led secondary transaction each year. Of these advisers, we further estimate that each conducts one adviser-led secondary transaction each year. As a result, an adviser would have

obligations under the proposed rule with regard to 67 investors.<sup>412</sup> As noted above, because the information collected pursuant to proposed rule 211(h)(2)–2 requires disclosures to private fund investors, these disclosures would not be kept confidential.

We have made certain estimates of this data solely for the purpose of this PRA analysis. The table below summarizes the annual burden estimates associated with the proposed rule's requirements.

TABLE 3—RULE 211(h)(2)–2 PRA ESTIMATES

	Internal initial burden hours	Internal annual burden hours	Wage rate <sup>1</sup>	Internal time cost	Annual external cost burden
<b>PROPOSED ESTIMATES</b>					
Preparation/Procurement of fairness opinion.	0	4 hours <sup>2</sup> .....	\$376.66 (blended rate for compliance attorney (\$373), assistant general counsel (\$476), and senior business analyst (\$281)).	\$1,506.64 .....	\$40,000. <sup>3</sup>
Preparation of material business relationship summary.	0	2 hours .....	\$424.50 (blended rate for compliance attorney (\$373) and assistant general counsel (\$476)).	\$849 .....	\$496. <sup>4</sup>
Distribution of fairness opinion and material business relationship summary.	0	1 hour .....	\$64 (rate for general clerk) .....	\$64 .....	\$0.
Total new annual burden per private fund.	.....	7 hours .....	.....	\$2,419.64 .....	\$40,849.
Number of advisers .....	.....	504 advisers <sup>5</sup> ....	.....	504 advisers .....	504 advisers.
Total new annual burden .....	.....	3,528 hours .....	.....	\$1,219,498.56 ...	\$20,587,896.

**Notes:**

<sup>1</sup> See SIFMA Report *supra* Note 1 to Table 1 Rule 211(h)(1)–2 PRA Estimates.

<sup>2</sup> Includes the time an adviser would spend gathering materials to provide to the independent opinion provider so that the latter can prepare the fairness opinion.

<sup>3</sup> This estimated burden is based on our understanding of the general cost of a fairness opinion in the current market. The cost will vary based on, among other things, the complexity, terms, and size of the adviser-led secondary transaction, as well as the nature of the assets of the fund.

<sup>4</sup> This estimated burden is based on the estimated wage rate of \$496/hour, for 1 hour, for outside legal services at the same frequency as the internal burden hours estimate. The Commission's estimates of the relevant wage rates for external time costs, such as outside legal services, takes into account staff experience, a variety of sources including general information websites, and adjustments for inflation.

<sup>5</sup> We estimate that 10% of all registered private fund advisers conduct in an adviser-led secondary transaction each year.

**E. Disclosure of Preferential Treatment**

Proposed rule 211(h)(2)–3 would prohibit all private fund advisers from providing preferential terms to certain investors regarding redemption or information about portfolio holdings or exposures.<sup>413</sup> The proposed rule would also prohibit these advisers from providing any other preferential treatment to any investor in the private fund unless the adviser provides written disclosures to prospective and current investors in a private fund regarding all preferential treatment the adviser or its related persons are providing to other investors in the same fund. For prospective investors, the proposed new rule would require advisers to provide the written notice prior to the investor's investment in the fund.<sup>414</sup> For current investors, the proposed new rule would require advisers to distribute an annual update regarding any preferential treatment provided since the last notice, if any.<sup>415</sup>

The proposed new rule is designed to protect investors and serve the public interest by requiring disclosure of preferential treatment afforded to certain investors. The proposed new rule would increase transparency in order to better inform investors regarding the breadth of preferential terms, the potential for those terms to affect their investment in the private fund, and the potential costs (including compliance costs) associated with these preferential terms. Also, this disclosure would help investors shape the terms of their relationship with the adviser of the private fund. The collection of information is necessary to provide private fund investors with information about their private fund investments.

Each requirement to disclose information, offer to provide information, or adopt policies and procedures constitutes a “collection of information” requirement under the PRA. This collection of information is found at 17 CFR 275.211(h)(2)–3 and is

mandatory. The respondents to these collections of information requirements would be all investment advisers that advise one or more private funds. Based on IARD data, as of November 30, 2021, there were 12,500 investment advisers that provide advice to private funds.<sup>416</sup> We estimate that these advisers would, on average, each provide advice to 7 private funds. We further estimate that these private funds would, on average, each have a total of 63 investors. As a result, an average private fund adviser would have a total of 441 investors across all private funds it advises. As noted above, because the information collected pursuant to proposed rule 211(h)(2)–3 requires disclosures to private fund investors and prospective investors, these disclosures would not be kept confidential.

We have made certain estimates of this data solely for the purpose of this PRA analysis. The table below summarizes the initial and ongoing annual burden estimates associated with

<sup>411</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1).

<sup>412</sup> See *supra* section V.B.

<sup>413</sup> See proposed rule 211(h)(2)–3(b).

<sup>414</sup> See proposed rule 211(h)(2)–3(b)(1).

<sup>415</sup> See proposed rule 211(h)(2)–3(b)(2).

<sup>416</sup> The following types of private fund advisers, among others, would be subject to the proposed

rule: Unregistered advisers (*i.e.*, advisers that are not SEC registered but have a registration obligation, and those that may be prohibited from registering with us), foreign private advisers, and advisers that rely on the intrastate exemption from SEC registration and/or the *de minimis* exemption from SEC registration. However, we are unable to estimate the number of advisers in each of these

categories because these advisers do not file reports or other information with the SEC and we are unable to find reliable, public information. As a result, the above estimate is based on information from SEC-registered advisers to private funds, exempt reporting advisers (at the state and Federal levels), and state-registered advisers to private funds. These figures are approximate.

the proposed rule's policies and procedures and annual review requirements.

TABLE 4—RULE 211(h)(2)–3 PRA ESTIMATES

	Internal initial burden hours	Internal annual burden hours	Wage rate <sup>1</sup>	Internal time cost	Annual external cost burden
<b>PROPOSED ESTIMATES</b>					
Preparation of written notice .....	4	3.3 hours <sup>2</sup> .....	\$424.50 (blended rate for compliance attorney (\$373) and assistant general counsel (\$476)).	\$1,400.85 .....	\$496. <sup>3</sup>
Provision/distribution of written notice .....	0.25	1.13 hours <sup>4</sup> .....	\$64 (rate for general clerk) .....	\$72.32..	
Total new annual burden per private fund .....		4.43 hours .....		\$1,473.17 .....	\$496.
Avg. number of private funds per adviser .....		7 private funds ..		7 private funds ..	7 private funds.
Number of advisers .....		12,500 advisers		12,500 advisers	9,375 advisers. <sup>5</sup>
Total new annual burden .....		387,625 hours ...		\$128,902,375 ....	\$32,550,000.

**Notes:**

<sup>1</sup> See SIFMA Report, *supra* Note 1 to Table 1 Rule 211(h)(1)–2 PRA Estimates.

<sup>2</sup> This includes the internal initial burden estimate annualized over a three-year period, plus 2 hours of ongoing annual burden hours and assumes notices would be issued once annually to existing investors and once quarterly for prospective investors. The estimate of 3.3 hours is based on the following calculation: ((4 initial hours/3 years) + 2 hours of additional ongoing burden hours) = 3.3 hours. The burden hours associated with reviewing preferential treatment provided to other investors in the same fund and updating the written notice takes into account that (i) most closed-end funds would only raise new capital for a finite period of time and thus the burden hours would likely decrease after the fundraising period terminates for such funds since they would not continue to seek new investors and would not continue to agree to new preferential treatment for new investors and (ii) most open-end private funds continuously raise capital and thus the burden hours would likely remain the same year over year since they would continue to seek new investors and would continue to agree to preferential treatment for new investors.

<sup>3</sup> This estimated burden is based on the estimated wage rate of \$496/hour, for 1 hours, for outside legal services at the same frequency as the internal burden hours estimate. The Commission's estimates of the relevant wage rates for external time costs, such as outside legal services, takes into account staff experience, a variety of sources including general information websites, and adjustments for inflation.

<sup>4</sup> This includes the internal initial burden estimate annualized over a three-year period, plus 1.05 hours of ongoing annual burden hours. The estimate of 1.13 hours is based on the following calculation: ((0.25 initial hours/3 years) + 1.05 hours of additional ongoing burden hours) = 1.13 hours.

<sup>5</sup> We estimate that 75% of advisers will use outside legal services for these collections of information. This estimate takes into account that advisers may elect to use outside legal services (along with in-house counsel), based on factors such as adviser budget and the adviser's standard practices for using outside legal services, as well as personnel availability and expertise.

#### F. Written Documentation of Adviser's Annual Review of Compliance Program

The proposed amendment to rule 206(4)–7 would require investment advisers that are registered or required to be registered to document the annual review of their compliance policies and procedures in writing.<sup>417</sup> We believe that such a requirement would focus renewed attention on the importance of the annual compliance review process and would help ensure that advisers maintain records regarding their annual

compliance review that will allow our staff to determine whether an adviser has complied with the compliance rule.

This collection of information is found at 17 CFR 275.206(4)–7 and is mandatory. The Commission staff uses the collection of information in its examination and oversight program. As noted above, responses provided to the Commission in the context of its examination and oversight program concerning the proposed amendments to rule 206(4)–7 would be kept

confidential subject to the provisions of applicable law.

Based on IARD data, as of November 30, 2021, there were 14,832 investment advisers registered with the Commission. In our most recent PRA submission for rule 206(4)–7, we estimated a total hour burden of 1,152,663 hours, and the total annual external cost burden is \$0.

The table below summarizes the initial and ongoing annual burden estimates associated with the proposed amendments to rule 204–2.

TABLE 5—RULE 206(4)–7 PRA ESTIMATES

	Internal annual burden hours	Wage rate <sup>1</sup>	Internal time cost	Annual external cost burden
<b>PROPOSED ESTIMATES</b>				
Written documentation of annual review .....	3 hours <sup>2</sup> .....	\$424.50 (blended rate for compliance attorney (\$373) and assistant general counsel (\$476)).	\$1,273.50 .....	\$551. <sup>3</sup>
Number of advisers .....	14,832 advisers		14,832 advisers	7,416 advisers. <sup>4</sup>
Total new annual burden .....	44,496 hours ....		\$18,888,552 ....	\$4,086,216.

**Notes:**

<sup>1</sup> See SIFMA Report, *supra* Note 1 to Table 1 Rule 211(h)(1)–2 PRA Estimates.

<sup>2</sup> We estimate that these proposed amendments would increase each registered investment adviser's average annual collection burden under rule 206(4)–7 by 3 hours.

<sup>3</sup> This estimated burden is based on the sum of the estimated wage rate of \$496/hour, for 0.5 hours, (\$248) for outside legal services and the estimated wage rate of \$310/hour, for 0.5 hours, (\$155) for outside accountant assistance.

<sup>4</sup> We estimate that 50% of advisers will use outside legal services for these collections of information. This estimate takes into account that advisers may elect to use outside legal services (along with in-house counsel), based on factors such as adviser budget and the adviser's standard practices for using outside legal services, as well as personnel availability and expertise.

<sup>417</sup> See proposed rule 206(4)–7(b).

*G. Recordkeeping*

The proposed amendments to rule 204–2 would require advisers to private funds to retain books and records related to the proposed quarterly statement rule, the proposed audit rule, the proposed adviser-led secondaries rule, and the proposed preferential treatment rule.<sup>418</sup> These proposed amendments would help facilitate the Commission's inspection and enforcement capabilities.

Specifically, the proposed books and records amendments related to the quarterly statement rule would require advisers to (i) retain a copy of any quarterly statement distributed to fund investors as well as a record of each addressee, the date(s) the statement was sent, address(es), and delivery method(s); (ii) retain all records evidencing the calculation method for all expenses, payments, allocations, rebates, offsets, waivers, and performance listed on any statement delivered pursuant to the proposed quarterly statement rule; and (iii) make and keep books and records substantiating the adviser's determination that the private fund it manages is a liquid fund or an illiquid fund pursuant to the proposed quarterly statement rule.<sup>419</sup>

The proposed books and records amendments related to the proposed audit rule would require advisers to keep a copy of any audited financial

statements along with a record of each addressee and the corresponding date(s) sent, address(es), and delivery method(s) for each such addressee.<sup>420</sup> Additionally, the proposed rule would require the adviser to keep a record documenting steps it took to cause a private fund client with which it is not in a control relationship to undergo a financial statement audit that would comply with the rule.<sup>421</sup>

The proposed books and records amendments related to the proposed adviser-led secondaries rule would require advisers to retain a copy of any fairness opinion and summary of material business relationships distributed pursuant to the proposed rule along with a record of each addressee and the corresponding date(s) sent, address(es), and delivery method(s) for each such addressee.<sup>422</sup>

The proposed books and records amendments related to the proposed preferential treatment rule would require advisers to retain copies of all written notices sent to current and prospective investors in a private fund pursuant to rule 211(h)(2)–3.<sup>423</sup> In addition, advisers would be required to retain copies of a record of each addressee and the corresponding dates sent, addresses, and delivery method for each addressee.<sup>424</sup>

The respondents to these collections of information requirements would be investment advisers that are registered

or required to be registered with the Commission that advise one or more private funds. Based on IARD data, as of November 30, 2021, there were 14,832 investment advisers registered with the Commission. According to this data, 5,037 registered advisers provide advice to private funds.<sup>425</sup> We estimate that these advisers would, on average, each provide advice to 9 private funds.<sup>426</sup> We further estimate that these private funds would, on average, each have a total of 67 investors.<sup>427</sup> As a result, an average private fund adviser would have, on average, a total of 603 investors across all private funds it advises.

In our most recent PRA submission for rule 204–2,<sup>428</sup> we estimated for rule 204–2 a total hour burden of 2,764,563 hours, and the total annual external cost burden is \$175,980,426. This collection of information is found at 17 CFR 275.204–2 and is mandatory. The Commission staff uses the collection of information in its examination and oversight program. As noted above, responses provided to the Commission in the context of its examination and oversight program concerning the proposed amendments to rule 204–2 would be kept confidential subject to the provisions of applicable law.

The table below summarizes the initial and ongoing annual burden estimates associated with the proposed amendments to rule 204–2.

TABLE 6—RULE 204–2 PRA ESTIMATES

	Internal annual burden hours <sup>1</sup>	Wage rate <sup>2</sup>	Internal time cost	Annual external cost burden
<b>PROPOSED ESTIMATES</b>				
Retention of account statement and calculation information; making and keeping records re liquid/illiquid fund determination.	0.25 hours .....	\$68 (blended rate for general clerk (\$64) and compliance clerk (\$72)).	\$17 .....	\$0
Avg. number of private funds per adviser.	9 private funds ..	.....	9 private funds ..	0
Number of advisers .....	5,037 advisers ..	.....	5,037 advisers ..	0
Sub-total burden .....	11,333.25 hours	.....	\$770,661 .....	0
Retention of written notices re preferential treatment.	0.5 hours .....	\$68 (blended rate for general clerk (\$64) and compliance clerk (\$72)).	\$34 .....	0
Avg. number of private funds per adviser.	7 private funds ..	.....	7 private funds ..	0
Number of advisers .....	5,037 advisers ..	.....	5,037 advisers ..	0
Sub-total burden .....	17,629.5 hours	.....	\$1,198,806 .....	0
Retention and distribution of audited financial statements.	0.25 hours .....	\$68 (blended rate for general clerk (\$64) and compliance clerk (\$72)).	\$17 .....	0

<sup>418</sup> See proposed rule 204–2.

<sup>419</sup> See proposed rule 204–2(a)(20)(i) and (ii) and (a)(22).

<sup>420</sup> See proposed rule 204–2(a)(21)(i).

<sup>421</sup> See proposed rule 204–2(a)(21)(ii).

<sup>422</sup> See proposed rule 204–2(a)(23).

<sup>423</sup> See proposed rule 204–2(a)(7)(v).

<sup>424</sup> *Id.*

<sup>425</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1).

<sup>426</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1).

<sup>427</sup> See Form ADV, Part 1A, Schedule D, Section 7.B.(1).A., #13.

<sup>428</sup> Supporting Statement for the Paperwork Reduction Act Information Collection Submission for Revisions to Rule 204–2, OMB Report, OMB 3235–0278 (Aug. 2021).

TABLE 6—RULE 204–2 PRA ESTIMATES—Continued

	Internal annual burden hours <sup>1</sup>	Wage rate <sup>2</sup>	Internal time cost	Annual external cost burden
Avg. number of private funds per adviser.	9 private funds ..	.....	9 private funds ..	0
Number of advisers .....	5,037 advisers ..	.....	5,037 advisers ..	0
Sub-total burden .....	11,333.25 hours	.....	\$770,661 .....	0
Retention and distribution of fairness opinion and summary of material business relationships.	1 hour .....	\$68 (blended rate for general clerk (\$64) and compliance clerk (\$72)).	\$68 .....	0
Avg. number of private funds per adviser that conduct an adviser-led transaction.	1 private fund ...	.....	1 private fund ...	0
Number of advisers .....	504 advisers <sup>3</sup> ...	.....	504 advisers <sup>4</sup> ...	0
Sub-total burden .....	504 hours .....	.....	\$34,272 .....	0
Total burden .....	40,800 hours ....	.....	\$ 2,774,400 .....	0

**Notes:**

<sup>1</sup> Hour burden and cost estimates for these proposed rule amendments assume the frequency of each collection of information for the substantive rule with which they are associated. For example, the hour burden estimate for recordkeeping obligations associated with the amendments to proposed rule 204–2(a)(20) and (22) would assume the same frequency of collection of information as under proposed rule 211(h)(1)–2.

<sup>2</sup> See SIFMA Report, *supra* Note 1 to Table 1 Rule 211(h)(1)–2 PRA Estimates.

<sup>3</sup> See *supra* section V.D.

<sup>4</sup> Id.

**H. Request for Comment**

We request comment on whether these estimates are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (1) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (2) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (4) determine whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed amendments should direct them to the OMB Desk Officer for the Securities and Exchange Commission, *MBX.OMB.OIRA.SEC\_desk\_officer@omb.eop.gov*, and should send a copy to Vanessa A. Countryman, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549–1090, with reference to File No. S7–03–22. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this release;

therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7–03–22, and be submitted to the Securities and Exchange Commission, Office of FOIA Services, 100 F Street NE, Washington, DC 20549–2736.

**VII. Initial Regulatory Flexibility Analysis**

The Commission has prepared the following Initial Regulatory Flexibility Analysis (“IRFA”) in accordance with section 3(a) of the Regulatory Flexibility Act (“RFA”).<sup>429</sup> It relates to the following proposed rules and rule amendments under the Advisers Act: (i) Proposed rule 211(h)(1)–1; (ii) proposed rule 211(h)(1)–2; (iii) proposed rule 206(4)–10; (iv) proposed rule 211(h)(2)–1; (v) proposed rule 211(h)(2)–2; (vi) proposed rule 211(h)(2)–3; (vii) proposed amendments to rule 204–2; and (viii) proposed amendments to rule 206(4)–7.

**A. Reasons for and Objectives of the Proposed Action****1. Proposed Rule 211(h)(1)–1**

We are proposing new rule 211(h)(1)–1 under the Advisers Act (the “definitions rule”), which would contain numerous definitions for

purposes of proposed rules 211(h)(1)–2, 206(4)–10, 211(h)(2)–1, 211(h)(2)–2, and 211(h)(2)–3.<sup>430</sup> We chose to include these definitions in a single rule for ease of reference, consistency, and brevity.

**2. Proposed Rule 211(h)(1)–2**

We are proposing new rule 211(h)(1)–2 under the Advisers Act, which requires any investment adviser registered or required to be registered with the Commission that provides investment advice to a private fund that has at least two full calendar quarters of operating results to prepare and distribute a quarterly statement to private fund investors that includes certain standardized disclosures regarding the cost of investing in the private fund and the private fund's performance.<sup>431</sup> We believe that providing this information to private fund investors in a simple and clear format is appropriate and in the public interest and will improve investor protection and investor decision making. The reasons for, and objectives of, proposed rule 211(h)(1)–2 are discussed in more detail in section II.A, above. The burdens of this requirement on small advisers are discussed below as well as above in sections V and VI, which discuss the burdens on all advisers. The professional skills required to meet these specific burdens also are also discussed in section VI.

<sup>430</sup> See proposed rule 211(h)(1)–1.

<sup>431</sup> See proposed rule 211(h)(1)–2.

<sup>429</sup> 5 U.S.C. 603(a).

### 3. Proposed Rule 206(4)–10

We are proposing new rule 206(4)-10 under the Advisers Act, which would generally require all investment advisers that are registered or required to be registered with the Commission to have their private fund clients undergo a financial statement audit at least annually and upon liquidation containing certain prescribed elements, which are described above in section II.B. The proposed rule is designed to provide protection for the fund and its investors against the misappropriation of fund assets and to provide an important check on the adviser's valuation of private fund assets, which often serve as the basis for the calculation of the adviser's fees. The reasons for, and objectives of, the proposed audit rule are discussed in more detail in section II.B, above. The burdens of these requirements on small advisers are discussed below as well as above in sections V and VI, which discuss the burdens on all advisers. The professional skills required to meet these specific burdens also are discussed in section VI.

### 4. Proposed Rule 211(h)(2)–1

Proposed rule 211(h)(2)-1 would prohibit all private fund advisers from, directly or indirectly, engaging in certain sales practices, conflicts of interest, and compensation schemes that are contrary to the public interest and the protection of investors. Specifically, the rule would prohibit an adviser from: (1) Charging certain fees and expenses to a private fund or portfolio investment (including accelerated monitoring fees, fees or expenses associated with an examination or investigation of the adviser or its related persons by governmental or regulatory authorities, regulatory or compliance expenses or fees of the adviser or its related persons, or fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment); (2) reducing the amount of any adviser clawback by the amount of certain taxes; (3) seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund; and (4) borrowing money, securities, or other fund assets, or receiving a loan or an extension of

credit, from a private fund client.<sup>432</sup> Each of these prohibitions is described in more detail above in section II.D. As discussed above, we believe that these sales practices, conflicts of interest, and compensation schemes must be prohibited. The proposed rule would prohibit these activities regardless of whether the private fund documents permit such activities or the adviser otherwise discloses the practices and regardless of whether the private fund investors have consented to the activities. Also, the proposed rule would prohibit these activities even if they are performed indirectly, for example by an adviser's related persons, because the activities have an equal potential to harm investors regardless of whether the adviser engages in the activity directly or indirectly. The reasons for, and objectives of, the proposed rule are discussed in more detail in section II.D, above. The burdens of these requirements on small advisers are discussed below as well as above in sections V and VI, which discuss the burdens on all advisers. The professional skills required to meet these specific burdens also are discussed in section VI.

### 5. Proposed Rule 211(h)(2)–2

We are proposing new rule 211(h)(2)-2 under the Advisers Act, which generally would make it unlawful for an adviser that is registered or required to be registered with the Commission to complete an adviser-led secondary transaction with respect to any private fund, where an adviser (or its related persons) offers fund investors the option to sell their interests in the private fund, or to convert or exchange them for new interests in another vehicle advised by the adviser or its related persons, unless the adviser, prior to the closing of the transaction, distributes to investors in the private fund a fairness opinion from an independent opinion provider and a summary of any material business relationships the adviser or any of its related persons has, or has had within the past two years, with the independent opinion provider. The specific requirements of the proposed rule are described above in section II.C. The proposed rule is designed to provide an important check against an adviser's conflicts of interest in structuring and leading a transaction from which it may stand to profit at the expense of private fund investors. The reasons for, and objectives of, the proposed rule are discussed in more detail in section II.C above. The burdens of these requirements on small advisers

are discussed below as well as above in sections V and VI, which discuss the burdens on all advisers. The professional skills required to meet these specific burdens also are discussed in section VI.

### 6. Proposed Rule 211(h)(2)–3

Proposed rule 211(h)(2)-3 would prohibit a private fund adviser, directly or indirectly, from (1) granting an investor in a private fund or in a substantially similar pool of assets the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets; or (2) providing information regarding the portfolio holdings or exposures of the private fund, or of a substantially similar pool of assets, to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets.<sup>433</sup> The proposed rule would also prohibit these advisers from providing any other preferential treatment to any investor in a private fund unless the adviser provides written disclosures to prospective and current investors in the private fund regarding all preferential treatment the adviser or its related persons provided to other investors in the same fund.<sup>434</sup> These requirements are described above in section II.E. The proposed rule is designed to eliminate sales practices that present a conflict of interest between the adviser and the private fund client that are contrary to the public interest and protection of investors. The disclosure elements of the proposed rule are designed to also help investors shape the terms of their relationship with the adviser of the private fund. The reasons for, and objectives of, the proposed rule are discussed in more detail in section II.E, above. The burdens of these requirements on small advisers are discussed below as well as above in sections V and VI, which discuss the burdens on all advisers. The professional skills required to meet these specific burdens also are discussed in section VI.

### 7. Proposed Amendments to Rule 204–2

We are also proposing related amendments to rule 204–2, the books and records rule, which sets forth various recordkeeping requirements for registered investment advisers. We are

<sup>433</sup> See proposed rule 211(h)(2)–3.

<sup>434</sup> See proposed rule 211(h)(2)–3(b).

<sup>432</sup> See proposed rule 211(h)(2)–1(a).

proposing to amend the current rule to require investment advisers to private funds to make and keep records relating to the quarterly statements required under proposed rule 211(h)(1)–2, the financial statement audits performed under proposed rule 206(4)–10, fairness opinions required under proposed rule 211(h)(2)–2, and disclosure of certain types of preferential treatment required under proposed rule 211(h)(2)–3. The reasons for, and objectives of, the proposed amendments to the books and records rule are discussed in more detail in sections II.A, II.B, II.C, II.E, V, above. The burdens of these requirements on small advisers are discussed below as well as above in sections V and VI, which discuss the burdens on all advisers. The professional skills required to meet these specific burdens also are discussed in section VI.

#### 8. Proposed Amendments to Rule 206(4)–(7)

We are proposing amendments to rule 206(4)–7 to require all SEC-registered advisers to document the annual review of their compliance policies and procedures in writing, as described above in section III. The proposed amendments are designed to focus renewed attention on the importance of the annual compliance review process and would better enable our staff to determine whether an adviser has complied with the review requirement of the compliance rule. The reasons for, and objectives of, the proposed rule are discussed in more detail in section III, above. The burdens of these requirements on small advisers are discussed below as well as above in sections V and VI, which discuss the burdens on all advisers. The professional skills required to meet these specific burdens also are discussed in section VI.

#### B. Legal Basis

The Commission is proposing new rules 211(h)(1)–2, 211(h)(2)–1, 211(h)(2)–2, 211(h)(2)–3, and 206(4)–10 under the Advisers Act under the authority set forth in sections 203(d), 206(4), 211(a), and 211(h) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–3(d), 80b–6(4) and 80b–11(a) and (h)). The Commission is proposing amendments to rule 204–2 under the Advisers Act under the authority set forth in sections 204 and 211 of the Investment Advisers Act of 1940 (15 U.S.C. 80b–4 and 80b–11). The Commission is proposing amendments to rule 206(4)–7 under the Advisers Act under the authority set forth in sections 203(d), 206(4), and 211(a) of the Investment Advisers Act of 1940 (15

U.S.C. 80b–3(d), 80b–6(4), and 80b–11(a)).

#### C. Small Entities Subject to Rules

In developing these proposals, we have considered their potential impact on small entities that would be subject to the proposed rules and amendments. Some of the proposed rules and amendments would affect many, but not all, investment advisers registered with the Commission, including some small entities, the proposed amendments to rule 206(4)–7 would affect all investment advisers that are registered, or required to be registered, with the Commission, including some small entities, and proposed rules 211(h)(2)–1 and 211(h)(2)–3 would apply to all advisers to private funds (even if not registered), including some small entities. Proposed rule 211(h)(1)–1 would affect all advisers, including all that are small entities, regardless of whether they are registered or advise private funds. Under Commission rules, for the purposes of the Advisers Act and the RFA, an investment adviser generally is a small entity if it: (1) Has assets under management having a total value of less than \$25 million; (2) did not have total assets of \$5 million or more on the last day of the most recent fiscal year; and (3) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of \$25 million or more, or any person (other than a natural person) that had total assets of \$5 million or more on the last day of its most recent fiscal year.<sup>435</sup>

Other than the proposed definitions rule, prohibitions rule and preferential treatment rule, our proposed rules and amendments would not affect most investment advisers that are small entities (“small advisers”) because those rules apply only to registered advisers, and small registered advisers are generally registered with one or more state securities authorities and not with the Commission. Under section 203A of the Advisers Act, most small advisers are prohibited from registering with the Commission and are regulated by state regulators. Based on IARD data, we estimate that as of November 30, 2021, approximately 594 SEC-registered advisers are small entities under the RFA.<sup>436</sup> All of these advisers would be affected by the proposed amendments to the compliance rule, and we estimate that approximately 29 advise one or more private funds and would,

therefore, be affected by the proposed quarterly statement rule, audit rule, and secondaries rule.

The proposed prohibited activities rule and the proposed preferential treatment rule, however, would have an impact on *all* investment advisers to private funds, regardless of whether they are registered with the Commission, one or more state securities authorities, or are unregistered. It is difficult for us to estimate the number of advisers not registered with us that have private fund clients. However, we are able to provide the following estimates based on IARD data. As of November 30, 2021, there are 5,022 ERAs, all of whom advise private funds, by definition.<sup>437</sup> All ERAs would, therefore, be subject to the rules that would apply to all private fund advisers. We estimate that there are no ERAs that would meet the definition of “small entity.”<sup>438</sup> We do not have a method for estimating the number of state-registered advisers to private funds that would meet the definition of “small entity.”

Additionally, the proposed prohibited activities rule and the proposed preferential treatment rule would apply to other advisers that are not registered with the SEC or with the states and that do not make filings with either the SEC or states. This includes foreign private advisers,<sup>439</sup> advisers that are entirely unregistered, and advisers that rely on the intrastate exemption from SEC registration and/or the de minimis exemption from SEC registration. We are unable to estimate the number of advisers in each of these categories because these advisers do not file reports or other information with the SEC and we are unable to find reliable, public information. As a result, our estimates are based on information from SEC-registered advisers to private funds, exempt reporting advisers (at the state and Federal levels), and state-registered advisers to private funds.

The proposed definitions rule would affect all advisers, but not unless the adviser is also affected by one of the rules discussed above. It has no independent substantive requirements or economic impacts. Therefore, the number of small advisers affected by this rule is accounted for in those

<sup>437</sup> See section 203(l) of the Advisers Act and 17 CFR 275.203(m)–1 (rule 203(m)–1 thereunder).

<sup>438</sup> In order for an adviser to be an SEC ERA it would first need to have an SEC registration obligation, and an adviser with that little in assets under management (*i.e.*, assets under management that is low enough to allow the adviser to qualify as a small entity) would not have an SEC registration obligation.

<sup>439</sup> See section 202(a)(30) of the Advisers Act (defining “foreign private adviser”).

<sup>435</sup> 17 CFR 275.0–7(a) (Advisers Act rule 0–7(a)).

<sup>436</sup> Based on SEC-registered investment adviser responses to Items 5.F. and 12 of Form ADV.



discussions and not separately and additionally delineated.

*D. Projected Reporting, Recordkeeping, and Other Compliance Requirements*

1. Proposed Rule 211(h)(1)–1

Proposed rule 211(h)(1)–1 would not impose any reporting, recordkeeping, or other compliance requirements on investment advisers because it has no independent substantive requirements or economic impacts. The rule would not affect an adviser unless it was complying with proposed rule 211(h)(1)–2, 206(4)–10, 211(h)(2)–1, 211(h)(2)–2, or 211(h)(2)–3, each of which is discussed below.

2. Proposed Rule 211(h)(1)–2

Proposed rule 211(h)(1)–2 would impose certain compliance requirements on investment advisers, including those that are small entities. It would require any investment adviser registered or required to be registered with the Commission that provides investment advice to a private fund that has at least two full calendar quarters of operating results to prepare and distribute quarterly statements with certain fee and expense and performance disclosure to private fund investors. The proposed requirements, including compliance and related recordkeeping requirements that would be required under the proposed amendments to rule 204–2 and rule 206(4)–7, are summarized in this IRFA (section VII above). All of these proposed requirements are also discussed in detail, above, in section II, and these requirements and the burdens on respondents, including those that are small entities, are discussed above in sections V and VI (the Economic Analysis and Paperwork Reduction Act Analysis, respectively) and below. The professional skills required to meet these specific burdens are also discussed in section VI.

As discussed above, there are approximately 29 small advisers to private funds currently registered with us, and we estimate that 100 percent of these advisers would be subject to the proposed rule 211(h)(1)–2. As discussed in our Paperwork Reduction Act Analysis in section V above, the proposed rule 211(h)(1)–2 under the Advisers Act, which would require advisers to prepare and distribute quarterly statements, would create a new annual burden of approximately 130.5 hours per adviser, or 3,784.5 hours in aggregate for small advisers. We therefore expect the annual monetized aggregate cost to small

advisers associated with our proposed amendments would be \$1,802,466.<sup>440</sup>

3. Proposed Rule 206(4)–10

Proposed rule 206(4)–10 would impose certain compliance requirements on investment advisers, including those that are small entities. All registered investment advisers that provide investment advice, including small entity advisers, would be required to comply with the proposed rule's requirements to have their private fund clients undergo a financial statement audit (at least annually and upon liquidation) and distribute audited financial statements to private fund investors. The proposed requirements, including compliance and related recordkeeping requirements that would be imposed under proposed amendments to rule 204–2 and rule 206(4)–7, are summarized in this IRFA (section VII.A. above). All of these proposed requirements are also discussed in detail, above, in section II, and these requirements and the burdens on respondents, including those that are small entities, are discussed above in sections V and VI (the Economic Analysis and Paperwork Reduction Act Analysis, respectively) and below. The professional skills required to meet these specific burdens are also discussed in section VI.

As discussed above, there are approximately 29 small advisers to private funds currently registered with us, and we estimate that 100 percent of these advisers would be subject to the proposed rule 206(4)–10. As discussed above in our Paperwork Reduction Act Analysis in section V above, proposed rule 206(4)–10 under the Advisers Act would create a new annual burden of approximately 18.36 hours per adviser, or 532.44 hours in aggregate for small advisers. We therefore expect the annual monetized aggregate cost to small advisers associated with our proposed amendments would be \$15,819,118.65.<sup>441</sup>

4. Proposed Rule 211(h)(2)–1

Proposed rule 211(h)(2)–1 would impose certain compliance requirements on investment advisers, including those that are small entities. Proposed rule 211(h)(2)–1 would prohibit all private fund advisers from engaging in certain sales practices,

<sup>440</sup> This includes the internal time cost and the annual external cost burden and assumes that, for purposes of the annual external cost burden, 50% of small advisers will use outside legal services, as set forth in the PRA estimates table.

<sup>441</sup> This includes the internal time cost and the annual external cost burden, as set forth in the PRA estimates table.

conflicts of interest, and compensation schemes that are contrary to the public interest and the protection of investors. Specifically, the rule would prohibit an adviser from: (1) Charging certain fees and expenses to a private fund or portfolio investment (including accelerated monitoring fees, fees or expenses associated with an examination or investigation of the adviser or its related persons by governmental or regulatory authorities, regulatory or compliance expenses or fees of the adviser or its related persons, or fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or propose to invest) in the same portfolio investment); (2) reducing the amount of any adviser clawback by the amount of certain taxes; (3) seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund; and (4) borrowing money, securities, or other fund assets, or receiving a loan or an extension of credit from a private fund client. All of these proposed requirements are also discussed in detail, above, in section II, and these requirements and the burdens on respondents, including those that are small entities, are discussed above in section V (the Economic Analysis) and below.

As discussed above, there are approximately 29 small advisers to private funds currently registered with us, and we estimate that 100 percent of these advisers would be subject to the proposed rule 211(h)(2)–1. As discussed above, we estimate that there are no ERAs that would meet the definition of “small entity” and we do not have a method for estimating the number of state-registered advisers to private funds that would meet the definition of “small entity.”<sup>442</sup>

5. Proposed Rule 211(h)(2)–2

Proposed rule 211(h)(2)–2 would impose certain compliance requirements on investment advisers, including those that are small entities. The rule generally would make it unlawful for an adviser that is registered or required to be registered with the Commission to complete an adviser-led secondary transaction with respect to any private fund, where an adviser (or its related persons) offers fund investors

<sup>442</sup> See *supra* section VI.C.

the option to sell their interests in the private fund, or to convert or exchange them for new interests in another vehicle advised by the adviser or its related persons, unless the adviser, prior to the closing of the transaction, distributes to investors in the private fund a fairness opinion from an independent opinion provider and a summary of any material business relationships the adviser or any of its related persons has, or has had within the past two years, with the independent opinion provider. The proposed requirements, including compliance and related recordkeeping requirements that would be imposed under proposed amendments to rule 204–2 and 206(4)–7, are summarized in this IRFA (section VII above). All of these proposed requirements are also discussed in detail, above, in section II, and these requirements and the burdens on respondents, including those that are small entities, are discussed above in sections V and VI (the Economic Analysis and Paperwork Reduction Act Analysis, respectively) and below. The professional skills required to meet these specific burdens also are discussed in section VI.

As discussed above, there are approximately 29 small advisers to private funds currently registered with us, and we estimate that 100 percent of these advisers would be subject to proposed rule 211(h)(2)–2. As discussed above in our Paperwork Reduction Act Analysis in section V above, proposed rule 211(h)(2)–2 under the Advisers Act would create a new annual burden of approximately 7 hours per adviser, or 21 hours in aggregate for small advisers.<sup>443</sup> We therefore expect the annual monetized aggregate cost to small advisers associated with our proposed amendments would be \$129,805.92.<sup>444</sup>

#### 6. Proposed Rule 211(h)(2)–3

Proposed rule 211(h)(2)–3 would impose certain compliance requirements on investment advisers, including those that are small entities. Proposed rule 211(h)(2)–3 would prohibit a private fund adviser, including indirectly through its related persons, from (1) granting an investor in the private fund or in a substantially similar pool of assets the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other

investors in that private fund or in a substantially similar pool of assets; and (2) providing information regarding the private fund's portfolio holdings or exposures of the private fund or of a substantially similar pool of assets to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a substantially similar pool of assets. The rule would also prohibit these advisers from providing any other preferential treatment to any investor in the private fund unless the adviser provides written disclosures to prospective and current investors in the private fund regarding all preferential treatment the adviser or its related persons provided to other investors in the same fund. The proposed requirements, including compliance and related recordkeeping requirements that would be imposed under proposed amendments to rule 204–2 and 206(4)–7, are summarized in this IRFA (section VII above). All of these proposed requirements are also discussed in detail, above, in section II, and these requirements and the burdens on respondents, including those that are small entities, are discussed above in sections V and VI (the Economic Analysis and Paperwork Reduction Act Analysis, respectively) and below. The professional skills required to meet these specific burdens also are discussed in section VI.

As discussed above, there are approximately 29 small advisers to private funds currently registered with us, and we estimate that 100 percent of these advisers would be subject to the proposed rule 211(h)(2)–3. As discussed above, we estimate that there are no ERAs that would meet the definition of “small entity” and we do not have a method for estimating the number of state-registered advisers to private funds that would meet the definition of “small entity.”<sup>445</sup> As discussed above in our Paperwork Reduction Act Analysis in section VI above, proposed rule 211(h)(2)–3 under the Advisers Act would create a new annual burden of approximately 31.01 hours per adviser, or 899.29 hours in aggregate for small advisers.<sup>446</sup> We therefore expect the

annual monetized aggregate cost to small advisers associated with our proposed amendments would be \$374,569.51.<sup>447</sup>

#### 7. Proposed Amendments to Rule 204–2

The proposed amendments to rule 204–2 would impose certain recordkeeping requirements on investment advisers to private funds, including those that are small entities. All registered investment advisers to private funds, including small entity advisers, would be required to comply with recordkeeping amendments. While all SEC-registered investment advisers, and advisers that are required to be registered, are subject to rule 204–2 under the Advisers Act, our proposed amendments to rule 204–2 would only impact private fund advisers that are SEC registered. The proposed amendments are summarized in this IRFA (section VII above). The proposed amendments are also discussed in detail, above, in section II, and the requirements and the burdens on respondents, including those that are small entities, are discussed above in sections V and VI (the Economic Analysis and Paperwork Reduction Act Analysis, respectively) and below. The professional skills required to meet these specific burdens also are discussed in section VI.

As discussed above, there are approximately 29 small advisers to private funds currently registered with us, and we estimate that 100 percent of advisers registered with us would be subject to the proposed amendments to rule 204–2. As discussed above in our Paperwork Reduction Act Analysis in section VI above, the proposed amendments to rule 204–2 under the Advisers Act, which would require advisers to retain certain copies of documents required under proposed rules 206(4)–10, 211(h)(1)–2, 211(h)(2)–2, and 211(h)(2)–3 would create a new annual burden of approximately 9 hours per adviser, or 261 hours in aggregate for small advisers. We therefore expect the annual monetized aggregate cost to small advisers associated with our

unable to find reliable, public information. As a result, the above estimate is based on information from SEC-registered advisers to private funds, exempt reporting advisers (at the state and Federal levels), and state-registered advisers to private funds. These figures are approximate.

<sup>447</sup> This includes the internal time cost and the annual external cost burden and assumes that, for purposes of the annual external cost burden, 75% of small advisers will use outside legal services, as set forth in the PRA estimates table.

<sup>443</sup> Similar to the PRA analysis, we assume that 10% (–3) of all small advisers will conduct an adviser-led secondary transaction on an annual basis.

<sup>444</sup> This includes the internal time cost and the annual external cost burden, as set forth in the PRA estimates table.

<sup>445</sup> See *supra* section VI.C.

<sup>446</sup> The following types of private fund advisers, among others, would be subject to the proposed rule: Unregistered advisers (*i.e.*, advisers that are not SEC registered but have a registration obligation), foreign private advisers, and advisers that rely on the intrastate exemption from SEC registration and/or the *de minimis* exemption from SEC registration. However, we are unable to estimate the number of advisers in each of these categories because these advisers do not file reports or other information with the SEC and we are

proposed amendments would be \$17,748.<sup>448</sup>

#### 8. Proposed Amendments to Rule 206(4)–7

Proposed amendments to rule 206(4)–7 would impose certain compliance requirements on investment advisers, including those that are small entities. All registered investment advisers, and advisers that are required to be registered, would be required to document the annual review of their compliance policies and procedures in writing. The proposed requirements are summarized in this IRFA (section VII above). All of these proposed requirements are also discussed in detail, above, in section III, and these requirements and the burdens on respondents, including those that are small entities, are discussed above in sections V and VI (the Economic Analysis and Paperwork Reduction Act Analysis, respectively) and below. The professional skills required to meet these specific burdens also are discussed in section VI.

As discussed above, there are approximately 29 small advisers currently registered with us, and we estimate that 100 percent of these advisers would be subject to the proposed amendments to rule 206(4)–7. As discussed above in our Paperwork Reduction Act Analysis in section VI above, these amendments would create a new annual burden of approximately 3 hour per adviser, or 87 hours in aggregate for small advisers. We therefore expect the annual monetized aggregate cost to small advisers associated with our proposed amendments would be \$44,921.<sup>449</sup>

#### *E. Duplicative, Overlapping, or Conflicting Federal Rules*

There are no duplicative, overlapping, or conflicting Federal rules with respect to the specific requirements of proposed rule 211(h)(1)–1, 211(h)(1)–2, 211(h)(2)–1, 211(h)(2)–2, 211(h)(2)–3, or the proposed amendments to rule 204–2 or rule 206(4)–7. We recognize that private fund advisers are prohibited from making misstatements or materially misleading statements to investors under rule 206(4)–8. To the extent there is any overlap between the proposed rules and rule 206(4)–8, we believe that any additional costs to advisers to

private funds would be minimal, as they can assume that conduct that would raise issues under any of the specific provisions of the proposed rules would also be prohibited under rule 206(4)–8. To the extent there is any overlap between the requirements of proposed rule 211(h)(1)–2 and Form ADV Part 2, it is minimal, and it is complementary, not contradictory. For example, Form ADV Part 2 requires advisers to disclose what fees the adviser charges, such as a 2% management fee based on its clients' assets that it manages. The proposed rule would require advisers to disclose what amount was actually charged to a private fund client (e.g., \$200,000).

There is significant duplication and overlap of the requirements of proposed rule 206(4)–10 and rule 206(4)–2 because proposed rule 206(4)–10 is drawn from the option to comply with rule 206(4)–2's account statement and surprise examination requirements by having pooled investment vehicle clients undergo a financial statement audit and distribute the financial statements to the investors in the pools. Similarities between these rules should result in minimal new compliance burdens for private fund advisers that have chosen to comply with the audit provision of rule 206(4)–2, however. For private fund advisers that have not chosen to comply with the audit provision of rule 206(4)–2, proposed rule 206(4)–10 will result in new compliance burdens, but not ones that contradict rule 206(4)–2. These advisers can choose to mitigate, as much as possible, their compliance burdens by electing to comply with rule 206(4)–2's audit provision in lieu of the account statement and surprise examination requirements, though this option may be limited for some advisers if they also have clients for which the adviser is unable to choose to rely on the audit provision of the custody rule. We believe these additional compliance burdens are justified because an audit by an independent public accountant would provide an important check on the adviser's valuation of private fund assets, which often serve as the basis for calculating the adviser's fees.

#### *F. Significant Alternatives*

The RFA directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the proposed rules and rule amendments, the Commission considered the following alternatives: (i) The establishment of differing compliance or reporting requirements or timetables that take into account the

resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the proposed rules and rule amendments for such small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the proposed rules and rule amendments, or any part thereof, for such small entities.

Regarding the first and fourth alternatives, we do not believe that differing compliance or reporting requirements or an exemption from coverage of the proposed rules and rule amendments, or any part thereof, for small entities, would be appropriate or consistent with investor protection. Because the protections of the Advisers Act are intended to apply equally to clients of both large and small advisory firms, it would be inconsistent with the purposes of the Act to specify different requirements for small entities under the proposed rules and rule amendments.

Regarding the second alternative, the proposed prohibited activities rule and the proposed preferential treatment rule are particularly intended to provide clarification to *all* private fund advisers, not just small advisers, as to what the Commission considers to be conduct that would be prohibited under section 206 of the Act and contrary to the public interest and protection of investors under section 211 of the Act. Despite our examination and enforcement efforts, this type of inappropriate conduct persists; these proposed rules will provide clarity of our views of this conduct to *all* private fund advisers. Similarly, we also have endeavored to consolidate and simplify the compliance with both proposed rules, as well as disclosure requirements under the proposed preferential treatment rule, for *all* private fund advisers.

Regarding the third alternative, we do not consider using performance rather than design standards to be consistent with our statutory mandate of investor protection with respect to preventing fraudulent, deceptive, or manipulative acts, or inappropriate sales practices, conflicts of interest or compensation schemes, by investment advisers.

#### *G. Solicitation of Comments*

We encourage written comments on matters discussed in this IRFA. In particular, the Commission seeks comment on:

- The number of small entities that would be affected by the proposed rule; and

<sup>448</sup> This includes the internal time cost and the annual external cost burden, as set forth in the PRA estimates table.

<sup>449</sup> This includes the internal time cost and the annual external cost burden and assumes that, for purposes of the annual external cost burden, 50% of small advisers will use outside legal services, as set forth in the PRA estimates table.

• whether the effect of the proposed rule on small entities would be economically significant.

Commenters are asked to describe the nature of any effect and provide empirical data supporting the extent of the effect.

### VIII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or “SBREFA,”<sup>450</sup> we must advise OMB whether a proposed regulation constitutes a “major” rule. Under SBREFA, a rule is considered “major” where, if adopted, it results in or is likely to result in (1) an annual effect on the economy of \$100 million or more; (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effects on competition, investment or innovation.

We request comment on the potential impact of the proposed rules and amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

### IX. Statutory Authority

The Commission is proposing new rules 211(h)(1)–1, 211(h)(1)–2, 211(h)(2)–1, 211(h)(2)–2, 211(h)(2)–3, and 206(4)–10 under the Advisers Act under the authority set forth in sections 203(d), 206(4), 211(a), and 211(h) of the Investment Advisers Act of 1940 [15 U.S.C. 80b–3(d), 80b–6(4) and 80b–11(a) and (h)]. The Commission is proposing amendments to rule 204–2 under the Advisers Act under the authority set forth in sections 204 and 211 of the Investment Advisers Act of 1940 [15 U.S.C. 80b–4 and 80b–11]. The Commission is proposing amendments to rule 206(4)–7 under the Advisers Act under the authority set forth in sections 203(d), 206(4), and 211(a) of the Investment Advisers Act of 1940 [15 U.S.C. 80b–3(d), 80b–6(4), and 80b–11(a)].

### List of Subjects in 17 CFR Part 275

Administrative practice and procedure, Reporting and recordkeeping requirements, Securities.

### Text of Proposed Rules

For the reasons set forth in the preamble, the Commission is proposing to amend title 17, chapter II of the Code of Federal Regulations as follows:

### PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

■ 1. The authority citation for part 275 continues to read in part as follows:

**Authority:** 15 U.S.C. 80b–2(a)(11)(G), 80b–2(a)(11)(H), 80b–2(a)(17), 80b–3, 80b–4, 80b–4a, 80b–6(4), 80b–6a, and 80b–11, unless otherwise noted.

Section 275.204–2 is also issued under 15 U.S.C. 80b–6.

■ 2. Amend § 275.204–2 by:

- a. Removing the period at the end of paragraph (a)(7)(iv)(B) and adding “; and” in its place; and
- b. Adding paragraphs (a)(7)(v) and (a)(20) through (23).

The additions read as follows:

#### § 275.204–2 Books and records to be maintained by investment advisers.

(a) \* \* \*

(7) \* \* \*

(v) Any notice required pursuant to § 275.211(h)(2)–3 as well as a record of each addressee and the corresponding date(s) sent, address(es), and delivery method(s) for each such addressee.

\* \* \* \* \*

(20)(i) A copy of any quarterly statement *distributed* pursuant to § 275.211(h)(1)–2, along with a record of each addressee and the corresponding date(s) sent, address(es), and delivery method(s) for each such addressee; and

(ii) All records evidencing the calculation method for all expenses, payments, allocations, rebates, offsets, waivers, and performance listed on any statement delivered pursuant to § 275.211(h)(1)–2.

(21) For each private fund client:

(i) A copy of any audited financial statements prepared and *distributed* pursuant to § 275.206(4)–10, along with a record of each addressee and the corresponding date(s) sent, address(es), and delivery method(s) for each such addressee; or

(ii) A record documenting steps taken by the adviser to cause a private fund client that the adviser does not control, is not controlled by, and with which it is not under common control to undergo a financial statement audit pursuant to § 275.206(4)–10.

(22) Documentation substantiating the adviser’s determination that a private fund client is a *liquid fund* or an *illiquid fund* pursuant to § 275.211(h)(1)–2.

(23) A copy of any *fairness opinion* and material business relationship summary *distributed* pursuant to § 275.211(h)(2)–2, along with a record of each addressee and the corresponding

date(s) sent, address(es), and delivery method(s) for each such addressee.

\* \* \* \* \*

■ 3. Amend § 275.206(4)–7 by revising paragraph (b) to read as follows:

#### § 275.206(4)–7 Compliance procedures and practices.

\* \* \* \* \*

(b) *Annual review.* Review and document in writing, no less frequently than annually, the adequacy of the policies and procedures established pursuant to this section and the effectiveness of their implementation; and

\* \* \* \* \*

■ 4. Section 275.206(4)–10 is added to read as follows:

#### § 275.206(4)–10 Private fund adviser audits.

As a means reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative, an investment adviser that is registered or required to be registered under section 203 of the Investment Advisers Act of 1940 shall cause each private fund that it advises, directly or indirectly, to undergo a financial statement audit as follows at least annually and upon liquidation, if the private fund does not otherwise undergo such an audit:

(a) The audit is performed by an independent public accountant that meets the standards of independence described in 17 CFR 210.2–01(b) and (c) [Rule 2–01(b) and (c) of Regulation S–X] and that is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board in accordance with its rules;

(b) The audit meets the definition in 17 CFR 210.1–02(d) [Rule 1–02(d) of Regulation S–X], the professional engagement period of which shall begin and end as indicated in Rule 2–01(f)(5) of Regulation S–X;

(c) Audited financial statements are prepared in accordance with U.S. Generally Accepted Accounting Principles (“U.S. GAAP”) or, in the case of financial statements of private funds organized under non-U.S. law or that have a general partner or other manager with a principal place of business outside the United States (“foreign private funds”), contain information substantially similar to statements prepared in accordance with U.S. GAAP and material differences with U.S. GAAP are reconciled;

(d) Promptly after the completion of the audit, the private fund’s audited financial statements, which includes any reconciliation to U.S. GAAP prepared for a foreign private fund, including supplementary U.S. GAAP disclosures, as applicable, are *distributed*;

(e) Pursuant to a written agreement between the independent public accountant

<sup>450</sup>Public Law 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

and the adviser or the private fund, the independent public accountant that completes the audit notifies the Commission by electronic means directed to the Division of Examinations:

(1) Promptly upon issuing an audit report to the private fund that contains a modified opinion; and

(2) Within four business days of resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed;

(f) For a private fund that the adviser does not *control* and is neither *controlled* by nor under common *control* with, the adviser is prohibited from providing investment advice, directly or indirectly, to the private fund if the adviser fails to take all reasonable steps to cause the private fund to undergo a financial statement audit that meets the requirements of paragraphs (a) through (e) of this section; and

(g) For purposes of this section, defined terms shall have the meanings set forth in § 275.211(h)(1)–1.

■ 5. Section 275.211(h)(1)–1 is added to read as follows:

**§ 275.211(h)(1)–1 Definitions.**

For purposes of §§ 275.206(4)–10, 275.211(h)(1)–2, 275.211(h)(2)–3, 275.211(h)(2)–1, and 275.211(h)(2)–2:

*Adviser clawback* means any obligation of the adviser, its *related persons*, or their respective owners or interest holders to restore or otherwise return *performance-based compensation* to the private fund pursuant to the private fund's governing agreements.

*Adviser-led secondary transaction* means any transaction initiated by the investment adviser or any of its *related persons* that offers private fund investors the choice to:

(1) Sell all or a portion of their interests in the private fund; or

(2) Convert or exchange all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its *related persons*.

*Committed capital* means any commitment pursuant to which a person is obligated to acquire an interest in, or make capital contributions to, the private fund.

*Control* means the power, directly or indirectly, to direct the management or policies of a person, whether through ownership of securities, by contract, or otherwise. For the purposes of this definition, control includes:

(1) Each of an investment adviser's officers, partners, or directors exercising executive responsibility (or persons having similar status or functions) is presumed to control the investment adviser;

(2) A person is presumed to control a corporation if the person:

(i) Directly or indirectly has the right to vote 25% or more of a class of the corporation's voting securities; or

(ii) Has the power to sell or direct the sale of 25% or more of a class of the corporation's voting securities;

(3) A person is presumed to control a partnership if the person has the right to receive upon dissolution, or has contributed, 25% or more of the capital of the partnership;

(4) A person is presumed to control a limited liability company if the person:

(i) Directly or indirectly has the right to vote 25% or more of a class of the interests of the limited liability company;

(ii) Has the right to receive upon dissolution, or has contributed, 25% or more of the capital of the limited liability company; or

(iii) Is an elected manager of the limited liability company; or

(5) A person is presumed to control a trust if the person is a trustee or managing agent of the trust.

*Covered portfolio investment* means a *portfolio investment* that allocated or paid the investment adviser or its *related persons portfolio investment compensation* during the *reporting period*.

*Distribute, distributes, or distributed* means send or sent to all of the private fund's investors; *provided that*, if an investor is a pooled investment vehicle that is *controlling, controlled* by, or under common *control* with (a "control relationship") the adviser or its *related persons*, the adviser must look through that pool (and any pools in a control relationship with the adviser or its *related persons*) in order to send to investors in those pools.

*Fairness opinion* means a written opinion stating that the price being offered to the private fund for any assets being sold as part of an *adviser-led secondary transaction* is fair.

*Fund-level subscription facilities* means any subscription facilities, subscription line financing, capital call facilities, capital commitment facilities, bridge lines, or other indebtedness incurred by the private fund that is secured by the *unfunded capital commitments* of the private fund's investors.

*Gross IRR* means an *internal rate of return* that is calculated gross of all fees, expenses, and *performance-based compensation* borne by the private fund.

*Gross MOIC* means a *multiple of invested capital* that is calculated gross of all fees, expenses, and *performance-based compensation* borne by the private fund.

*Illiquid fund* means a private fund that:

(1) Has a limited life;

(2) Does not continuously raise capital;

(3) Is not required to redeem interests upon an investor's request;

(4) Has as a predominant operating strategy the return of the proceeds from disposition of investments to investors;

(5) Has limited opportunities, if any, for investors to withdraw before termination of the fund; and

(6) Does not routinely acquire (directly or indirectly) as part of its investment strategy market-traded securities and derivative instruments.

*Independent opinion provider* means an entity that:

(1) Provides *fairness opinions* in the ordinary course of its business; and

(2) Is not a *related person* of the adviser.

*Internal rate of return* means the discount rate that causes the net present value of all cash flows throughout the life of the fund to be equal to zero.

*Liquid fund* means a private fund that is not an *illiquid fund*.

*Multiple of invested capital* means, as of the end of the applicable calendar quarter:

(1) The sum of:

(i) The unrealized value of the *illiquid fund*; and

(ii) The value of all distributions made by the *illiquid fund*;

(2) Divided by the total capital contributed to the *illiquid fund* by its investors.

*Net IRR* means an *internal rate of return* that is calculated net of all fees, expenses, and *performance-based compensation* borne by the private fund.

*Net MOIC* means a *multiple of invested capital* that is calculated net of all fees, expenses, and *performance-based compensation* borne by the private fund.

*Performance-based compensation* means allocations, payments, or distributions of capital based on the private fund's (or its *portfolio investments*) capital gains and/or capital appreciation.

*Portfolio investment* means any entity or issuer in which the private fund has directly or indirectly invested.

*Portfolio investment compensation* means any compensation, fees, and other amounts allocated or paid to the investment adviser or any of its *related persons* by the *portfolio investment* attributable to the private fund's interest in such *portfolio investment*, including, but not limited to, origination, management, consulting, monitoring, servicing, transaction, administrative,

advisory, closing, disposition, directors, trustees or similar fees or payments.

*Related person* means:

- (1) All officers, partners, or directors (or any person performing similar functions) of the adviser;
- (2) All persons directly or indirectly controlling or controlled by the adviser;
- (3) All current employees (other than employees performing only clerical, administrative, support or similar functions) of the adviser; and
- (4) Any person under common *control* with the adviser.

*Reporting period* means the private fund's calendar quarter covered by the quarterly statement or, for the initial quarterly statement of a newly formed private fund, the period covering the private fund's first two full calendar quarters of operating results.

*Statement of Contributions and Distributions* means a document that presents:

- (1) All capital inflows the private fund has received from investors and all capital outflows the private fund has distributed to investors since the private fund's inception, with the value and date of each inflow and outflow; and
- (2) The net asset value of the private fund as of the end of the *reporting period*.

*Substantially similar pool of assets* means a pooled investment vehicle (other than an investment company registered under the Investment Company Act of 1940 or a company that elects to be regulated as such) with substantially similar investment policies, objectives, or strategies to those of the *private fund* managed by the investment adviser or its *related persons*.

*Unfunded capital commitments* means *committed capital* that has not yet been contributed to the private fund by investors.

■ 6. Section 275.211(h)(1)–2 is added to read as follows:

**§ 275.211(h)(1)–2 Private fund quarterly statements.**

(a) *Quarterly statements.* As a means reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative, an investment adviser that is registered or required to be registered under section 203 of the Investment Advisers Act of 1940 shall prepare a quarterly statement that complies with paragraphs (a) through (g) of this section for any private fund that it advises, directly or indirectly, that has at least two full calendar quarters of operating results, and distribute the quarterly statement to the private fund's investors within 45 days after each

calendar quarter end, unless such a quarterly statement is prepared and distributed by another person.

(b) *Fund table.* The quarterly statement must include a table for the private fund that discloses, at a minimum, the following information, presented both before and after the application of any offsets, rebates, or waivers for the information required by paragraphs (b)(1) and (2) of this section:

(1) A detailed accounting of all compensation, fees, and other amounts allocated or paid to the investment adviser or any of its *related persons* by the fund during the *reporting period*, with separate line items for each category of allocation or payment reflecting the total dollar amount, including, but not limited to, management, advisory, sub-advisory, or similar fees or payments, and *performance-based compensation*;

(2) A detailed accounting of all fees and expenses paid by the private fund during the *reporting period* (other than those listed in paragraph (b)(1) of this section), with separate line items for each category of fee or expense reflecting the total dollar amount, including, but not limited to, organizational, accounting, legal, administration, audit, tax, due diligence, and travel fees and expenses; and

(3) The amount of any offsets or rebates carried forward during the *reporting period* to subsequent periods to reduce future payments or allocations to the adviser or its *related persons*.

(c) *Portfolio investment table.* The quarterly statement must include a separate table for the private fund's *covered portfolio investments* that discloses, at a minimum, the following information for each *covered portfolio investment*:

(1) A detailed accounting of all *portfolio investment compensation* allocated or paid to the investment adviser or any of its *related persons* by the *covered portfolio investment* during the *reporting period*, with separate line items for each category of allocation or payment reflecting the total dollar amount, presented both before and after the application of any offsets, rebates, or waivers; and

(2) The fund's ownership percentage of each such *covered portfolio investment* as of the end of the *reporting period*, or zero, if the fund does not have an ownership interest in the *covered portfolio investment*, along with a brief description of the fund's investment.

(d) *Calculations and cross references.* The quarterly statement must include prominent disclosure regarding the manner in which all expenses,

payments, allocations, rebates, waivers, and offsets are calculated and include cross references to the sections of the private fund's organizational and offering documents that set forth the applicable calculation methodology.

(e) *Performance.* (1) No later than the time the adviser sends the initial quarterly statement, the adviser must determine that the private fund is an *illiquid fund* or a *liquid fund*.

(2) The quarterly statement must present the following with equal prominence:

(i) *Liquid funds.* For a *liquid fund*:

- (A) Annual net total returns for each calendar year since inception;
- (B) Average annual net total returns over the one-, five-, and ten- calendar year periods; and
- (C) The cumulative net total return for the current calendar year as of the end of the most recent calendar quarter covered by the quarterly statement.

(ii) *Illiquid funds.* For an *illiquid fund*:

(A) The following performance measures, shown since inception of the *illiquid fund* through the end of the quarter covered by the quarterly statement (or, to the extent quarter-end numbers are not available at the time the adviser distributes the quarterly statement, through the most recent practicable date) and computed without the impact of any *fund-level subscription facilities*:

(1) *Gross IRR* and *gross MOIC* for the *illiquid fund*;

(2) *Net IRR* and *net MOIC* for the *illiquid fund*;

(3) *Gross IRR* and *gross MOIC* for the realized and unrealized portions of the *illiquid fund's* portfolio, with the realized and unrealized performance shown separately; and

(4) A *statement of contributions and distributions* for the *illiquid fund*.

(B) [Reserved]

(iii) The quarterly statement must include the date as of which the performance information is current through and prominent disclosure of the criteria used and assumptions made in calculating the performance.

(f) *Consolidated reporting.* To the extent doing so would provide more meaningful information to the private fund's investors and would not be misleading, the adviser must consolidate the reporting required by paragraphs (a) through (e) of this section to cover *substantially similar pools of assets*.

(g) *Format and content.* The quarterly statement must use clear, concise, plain English and be presented in a format that facilitates review from one quarterly statement to the next.

(h) *Definitions*. For purposes of this section, defined terms shall have the meanings set forth in § 275.211(h)(1)–1. ■ 7. Section 275.211(h)(2)–1 is added to read as follows:

**§ 275.211(h)(2)–1 Private fund adviser prohibited activities.**

(a) An investment adviser to a private fund may not, directly or indirectly, do the following with respect to the private fund, or any investor in that private fund:

(1) Charge a *portfolio investment* for monitoring, servicing, consulting, or other fees in respect of any services that the investment adviser does not, or does not reasonably expect to, provide to the *portfolio investment*;

(2) Charge the private fund for fees or expenses associated with an examination or investigation of the adviser or its *related persons* by any governmental or regulatory authority;

(3) Charge the private fund for any regulatory or compliance fees or expenses of the adviser or its *related persons*;

(4) Reduce the amount of any *adviser clawback* by actual, potential, or hypothetical taxes applicable to the adviser, its *related persons*, or their respective owners or interest holders;

(5) Seek reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund;

(6) Charge or allocate fees and expenses related to a *portfolio investment* (or potential *portfolio investment*) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its *related persons* have invested (or propose to invest) in the same *portfolio investment*; and

(7) Borrow money, securities, or other private fund assets, or receive a loan or

an extension of credit, from a private fund client.

(b) For purposes of this section, defined terms shall have the meanings set forth in § 275.211(h)(1)–1.

■ 8. Section 275.211(h)(2)–2 is added to read as follows:

**§ 275.211(h)(2)–2 Adviser-led secondaries.**

(a) As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts, practices, or courses of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b–6(4)), it is unlawful for any investment adviser that is registered or required to be registered under section 203 of the Act to complete an *adviser-led secondary transaction* with respect to any private fund, unless the adviser:

(1) Obtains, and *distributes* to investors in the private fund, a *fairness opinion* from an *independent opinion provider*; and

(2) Prepares, and *distributes* to investors in the private fund, a written summary of any material business relationships the adviser or any of its *related persons* has, or has had within the past two years, with the *independent opinion provider*, in each case, prior to the closing of the *adviser-led secondary transaction*.

(b) For purposes of this section, defined terms shall have the meanings set forth in § 275.211(h)(1)–1.

■ 9. Section 275.211(h)(2)–3 is added to read as follows:

**§ 275.211(h)(2)–3 Preferential treatment.**

(a) An investment adviser to a private fund may not, directly or indirectly, do the following with respect to the private fund, or any investor in that private fund:

(1) Grant an investor in the private fund or in a *substantially similar pool of assets* the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that

private fund or in a *substantially similar pool of assets*; or

(2) Provide information regarding the portfolio holdings or exposures of the private fund, or of a *substantially similar pool of assets*, to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors in that private fund or in a *substantially similar pool of assets*.

(b) An investment adviser to a private fund may not, directly or indirectly, provide any other preferential treatment to any investor in the private fund unless the adviser provides written notices as follows:

(1) *Advance written notice for prospective investors in a private fund*. The investment adviser shall provide to each prospective investor in the private fund, prior to the investor's investment in the private fund, a written notice that provides specific information regarding any preferential treatment the adviser or its related persons provide to other investors in the same private fund.

(2) *Annual written notice for current investors in a private fund*. The investment adviser shall *distribute* to current investors, on at least an annual basis, a written notice that provides specific information regarding any preferential treatment provided by the adviser or its related persons to other investors in the same private fund since the last written notice provided in accordance with this section, if any.

(c) For purposes of this section, defined terms shall have the meanings set forth in § 275.211(h)(1)–1.

By the Commission.

Dated: February 9, 2022.

**Vanessa A. Countryman,**  
*Secretary.*

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